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Decision_______________

BEFORE THE PUBLIC UTILITIES COMMISSION OF THE STATE OF CALIFORNIA

In the Matter of the Application of SAN GABRIEL VALLEY WATER COMPANY (U337W) for Authority to Increase Rates Charged for Water Service in its Fontana Water Company Division by $5,662,900 or 13.1% in July 2006; $3,072,500 or 6.3% in July 2007; and by $2,196,000 or 4.2% in July 2008.	Application 05-08-021 (Filed August 5, 2005)

(See Appendix C for List of Appearances)

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I. Background and Procedural History

San Gabriel Valley Water Company (San Gabriel) is a Class A water utility providing public utility water service to approximately 88,000 customers in Los Angeles and San Bernardino Counties. The company's Fontana Water Company Division (Fontana Division) serves approximately 43,000 customers in a service area that includes most of the City of Fontana, portions of the cities of Rancho Cucamonga and Rialto, and adjacent unincorporated areas of western San Bernardino County. The region is characterized by population growth and significant water quality problems.

San Gabriel's last general rate case (GRC) application for the Fontana Division, Application (A.) 02-11-044, resulted in Decision (D.) 04-07-034, which increased rates effective July 17, 2004. Those rates were set subject to refund pending further review and consideration of the appropriate ratemaking treatment of the proceeds of certain sales and involuntary conversions of Fontana Division properties that was considered but not finally resolved in the course of that proceeding. D.04-07-034 directed the Water Division to conduct an audit of those proceeds and directed San Gabriel to make a further showing with respect to them in the next GRC. In August 2005, the Commission responded to applications for rehearing of D.04-07-034 by issuing D.05-08-041, granting rehearing of D.04-07-034 for certain issues, and specifying that currently authorized rates for the Fontana Division are subject to refund.

Meanwhile, San Gabriel tendered on June 6, 2005, its proposed application for a general rate increase for Test Years (TY) 2006-2007 and escalation years 2007-2008 and 2008-2009. After review by the Division of

Ratepayers Advocates (DRA), San Gabriel corrected deficiencies and with DRA's approval filed its GRC application on August 5, 2005, seeking an increase in rates of $5.7 million (13.1%) for TY 2006-2007, $3.1 million (6.3%) for escalation year 2007-2008, and $2.2 million (4.2%) for escalation year 2008-2009. Protests of A.05-08-021 were filed by the City of Fontana (City), the Fontana Unified School District (District), and DRA. On September 19, 2005, Water Division issued its audit report on the results of its examination of San Gabriel's property sales and condemnations.

Public participation hearings were held on November 17, 2005. Beginning on January 9, 2006, seven days of evidentiary hearings were held. The record was submitted for decision on January 20, 2006, subject to the receipt of late-filed exhibits and opening and reply briefs.

II. Water Sales and Operating Revenues

The Company's forecast of active service connections, sales, and operating revenues by customer class for year 2005, TY 2006-2007, and the two escalation years were adopted for the most part. Only a few aspects of those calculations and forecasts were contested. San Gabriel's forecast that its number of active service connections will increase at a rate of 1,350 new connections per year was accepted. DRA accepted all San Gabriel's estimates of service connections and its estimates of annual use by every customer class except for large industrial customers.

III. Service Connections

Recent and anticipated growth in the Fontana Division consists mainly of single-family residences in the northern portion of the service area, with only nominal increases in other customer classes. San Gabriel's forecast of growth in service connections was determined by adding the average growth per customer class over the past five years to the previous year's total. San Gabriel's growth forecast was accepted by DRA.

IV. Annual Use by Customer Class

A. Average Use Per Customer

San Gabriel forecasts sales on a weather-normalized basis for most customer classes by applying the New Committee Method to recorded monthly sales over the last ten years. This forecast method was accepted by DRA.

B. Sales to Cemex and California Steel Industries

The only real disagreement over customer sales concerned San Gabriel's estimates of sales to two large customers in the Large Industrial class – California Steel Industries (CSI) and Cemex. A San Gabriel witness testified that he met with the plant manager and other management officials of Cemex to determine Cemex water needs over the next three years. Cemex said that its water use for the next three years would remain about the same as it has been in the recent past.

DRA's witness testified that San Gabriel's estimate of sales to Cemex was based on a ten-year average, and proposed instead an estimate based on the average of the two most recent recorded fiscal years. This produced an estimate of test year sales to Cemex of 250,685 one hundred cubic feet (ccf) as compared to San Gabriel's estimate of 223,666 ccf. DRA's recommendation is more reflective of Cemex's current and anticipated water use, and will be adopted.

In regard to CSI, San Gabriel's witness testified that San Gabriel officers had met with representatives of CSI in May 2005 and were informed that CSI had decided to rehabilitate its existing on-site well to produce its own water and had spent $900,000 so far on the project, which is expected to be completed later in 2005. CSI will still rely on San Gabriel for part of its supply and as a backup source of supply. San Gabriel estimates that San Gabriel's sales to CSI will be reduced by over 566,000 ccf per year.

DRA challenged San Gabriel's assumption that CSI will use its entire 1,300 acre-feet per year (AFY) of water rights. DRA's witness testified that a CSI officer contacted by DRA could not give clear-cut information regarding amounts CSI intends to self-provide. DRA recommended that sales to CSI be projected at 545,700 ccf, a level 283,140 ccf higher than San Gabriel's test year estimate, reflecting a 50% reduction in sales compared to San Gabriel's projected reduction. As San Gabriel has not produced persuasive evidence regarding CSI water demand, we will adopt DRA's more conservative estimate.

C. Miscellaneous and Construction Revenues

Miscellaneous Revenues are revenues recorded in Accounts 611 and 614. The revenues recorded in Account 611 consist primarily of reconnection fees collected from customers, which San Gabriel based on a five-year average in its forecast. The revenues recorded in account 614 consist primarily of reimbursements received by San Gabriel from third parties, mainly from the County of San Bernardino. DRA accepts the amount proposed by San Gabriel for Miscellaneous Revenues in the forecasted TY 2006-2007, with one exception. In August 2005, San Gabriel received $116,909 from the West Valley Water District, acting as a disbursement agent on behalf of the United States Environmental Protection Agency (US EPA), for grant funds for the reimbursement of certain operation and maintenance (O&M) costs incurred at Plant F17. DRA recommends Miscellaneous

Revenues be increased by $116,909 to reflect an annual level of grant revenues. DRA also recommends that if future grant proceeds are received by San Gabriel in excess of the $116,909, then the excess amounts should be included in the Water Quality Memorandum Account (WQMA) for future benefit to ratepayers. San Gabriel's witness testified that this is a one-time reimbursement. San Gabriel agrees to adjust the test year forecast by one-third of the amount, or $38,970. DRA asserts that the company's data response indicated that additional US EPA funds would be forthcoming. Thus, contrary to San Gabriel's position, these funds will continue to be paid to San Gabriel on an annual basis.

DRA's assumption that the US EPA will give San Gabriel a grant of $116,909 in each escalation year is speculative at best. Including $116,909 in the test year Miscellaneous Revenues would give the ratepayers three times the benefit of a one-time payment. Should additional grant money be received by San Gabriel, the company has agreed that that money would be recorded in its WQMA for the benefit of ratepayers. San Gabriel's approach to the allocation of the $116,909 is to amortize it over three years, increasing the water revenue account by $38,970 in the test year. San Gabriel's proposal is reasonable and is adopted.

V. Operating and Administrative Expenses

A. Supply Costs

1. Unmetered and Unaccounted for Water

Unaccounted water is the amount lost through operations and leakage and the difference between the total amount of water produced and the total amount water recorded for sales. DRA agrees with San Gabriel's proposed 6.2% unaccounted for water factor. It will be adopted.

2. Recycled Water

San Gabriel seeks to develop a capability to supply reclaimed water to satisfy special needs of some customers. A San Gabriel witness described a series of communications between San Gabriel and Fontana regarding the possible purchase of recycled water from the City, but said the City failed to produce any definite information about the availability or price of recycled water. San Gabriel is very much interested in the City's still-pending Recycled Water Feasibility Study/Master Plan and will meet with City officials upon its completion.

The City took a different view of the recycled water issue. Its witness said San Gabriel has failed to propose a solution that helps reduce rates. The witness said the City generates over 11.5 million gallons per day (mgd) of wastewater and participates in a regional program Recycled Water Master Plan to deliver recycled water to participating agencies. He said the City would like to enter into a recycled water proposal with San Gabriel but that San Gabriel has been unclear in its position when working with the City to develop a suitable recycled water serving arrangement.

This issue generated much acrimony between the City and San Gabriel. The parties seemed to be talking past each other rather than with each other. Recycling wastewater is an important conservation measure. We will direct the Water Division to offer a mediation service to assist the parties in achieving a solution.

3. Water Costs

DRA has reached an agreement with San Gabriel that San Gabriel's proposed $8,509,500 water costs (177.88/AF) forecast for TY 2006-2007, is reasonable. However, as DRA has recommended an adjustment to increase the company's projected sales to CSI by 650 AF, DRA has also increased the projected purchase water costs by $115,622 (650 AF x $177.88/AF) to $8,625,122.

San Gabriel contends that DRA's adjustment to water costs is inadequate, because DRA's higher cost estimate reflects only its forecast of higher sales to CSI and not its forecast of higher sales to Cemex, reflects only net sales rather than water production requirements (including the agreed upon 6.2% water loss factor), and is improperly based on average cost rather than incremental cost. Thus, if the Commission were to accept the higher estimates of sales to CSI and Cemex that DRA proposes, the increase in purchased water costs would be $209,102 rather than $115,622. We disagree with San Gabriel. Because the actual purchased water costs go through a full cost balancing account we see no need to adopt the higher estimate.

4. Purchased Power Costs

DRA has reached an agreement with San Gabriel that its proposed $4,659,500, or $0.094782/kWh, forecast for TY 2006-2007 is reasonable. The actual purchased power costs go through a full cost balancing account.

5. Chemical Expense

San Gabriel estimates that its annual chemical expense will increase from the actual 2004 amount of $140,544 to TY 2006-2007 cost of $680,110, an increase of 384%. The forecasted increases are due to the resin replacement at Plant F17 beginning 2005 and the projected additional cost beginning in 2007 for chemicals associated with the Sandhill Treatment Plant upgrade.

The treatment facility at Plant F17 is an ion exchange facility used for the removal of perchlorate. DRA concurs with San Gabriel on the amount for chemical costs for Plant F17.

For the Sandhill Treatment Plant upgrade, San Gabriel included projected chemical expenses for TY 2006-2007 based on 50% of projected 2006 expenses of $148,872 and 50% of the projected 2007 expenses of $404,107. San Gabriel based the projected 2007 increase on a comparison of the estimated chemical costs of operating the upgraded plant with the Cucamonga Valley Water District's costs of operating a similar water treatment plant.

In response to discovery by DRA, San Gabriel indicated that the projected in-service date for the Sandhill plant upgrade is not until August 2007 which is after the end of TY 2006-2007. Thus, DRA recommends that the chemical costs for the Sandhill plant for TY 2006-2007 be based on San Gabriel's projected 2006 pre-update cost of $148,872, resulting in a $128,000 reduction to San Gabriel's proposed chemical expense.

We agree with both parties. We should avoid including an expense in the test year which will not be incurred in the test year. Nor should we deny the known expense in the escalation year. To resolve the issue, we will amortize the two years of the expenses over the three year period. Therefore, we will reduce San Gabriel's chemical expense by $42,700. ($128,000 ÷ 3 = $42,700 (rounded).) The reasonable expense is $637,410.

B. Other Expenses

1. Escalation Factors

For the majority of the O&M expenses and Administrative & General expenses, other than payroll, San Gabriel forecasted expenses utilizing a five-year average of recorded data from 2000-2004, adjusted to 2004 dollars, and applied escalation factors in determining the future amounts. In applying escalation factors for the test year and escalation years, San Gabriel utilized June 30, 2005 publications from the DRA Energy Cost of Service Branch (ECSB). DRA recommended that San Gabriel utilize the more recent ECSB memorandum, dated September 30, 2005 to update the inflation factors, and San Gabriel has agreed.

2. Materials and Supplies Expense

DRA did not take issue with the projected amount of materials and supplies expense included by San Gabriel, which was based predominately on the five-year average expense levels, escalated to test year dollars. Using the updated September 30, 2005 escalation factors, DRA's recommendations for materials and supplies expenses are: $142,300 for operations, $282,900 for maintenance and $40,300 for administrative and general expenses. These amounts are $1,500, $3,100, and $400 higher than San Gabriel's proposed amounts, respectively. San Gabriel does not object; DRA's recommendation is adopted.

3. Transportation Expense

San Gabriel's projected TY 2006-2007 O&M expenses include $628,306 for transportation expenses, which include a 1% escalation increase each year from 2005-2007 to adjust for the purchase of additional vehicles. After discussions with company employees, DRA says San Gabriel has not based the 1% on any calculations or studies. Thus, there is no support for the additional 1% increase factor. DRA recommends a TY 2006-2007 expense of $619,323, which is a reduction of $8,983, reflecting the removal of the additional 1% annual increases. DRA's recommendation is adopted.

4. Postage

In projecting TY 2006-2007 postage expense, the company applied non-labor escalation rates as well as the 5.4% postage rate increase. DRA agrees.

5. Outside Services Expense - Other than Legal Expenses

The maintenance expense element of outside services varies directly with the quantities of physical plant. San Gabriel increased to $187,100 the recorded year 2004 amount to reflect both increases in plant and non-labor escalation rates. DRA recommended reducing maintenance expense by $9,900 to reflect DRA's proposed disallowance of new wells and emergency generators and DRA's application of more recent escalation factors. DRA also disagreed with San Gabriel's justification that the cost of maintaining mains, service connections, and hydrants will increase as the number of units of such plant increases; DRA estimated this cost based on a simple five-year average with no reflection of the increasing number of such facilities.

San Gabriel argues that maintenance expense necessarily varies with the volume of plant to be maintained. As quantities of plant increase over time, it is unrealistic to estimate future maintenance cost solely on a simple five-year average. We agree. As we are not disallowing new wells and generators, San Gabriel's estimate of this expense item is more reasonable than that of DRA, and is adopted.

6. Outside Services – Legal Expenses

a) Non-Perchlorate-Related Legal Expenses

San Gabriel estimated $287,795 in TY 2006-2007 for non-perchlorate related legal costs, based on a ten-year average expense level, inflated to 2004 dollars, then escalated to TY 2006-2007 utilizing the June 2005 escalation factors. Analysis shows that the escalated cost for the two oldest years, 1995 and 1996, are significantly higher than any of the other years reflected.

DRA reviewed the legal costs included in each of the 10 years included in the calculations and determined there was a significant impact from the going-forward cost estimates. DRA recommends that the non-perchlorate related legal costs be computed on a recent five-year average, inflated to 2004 dollars and escalated to the 2006-2007 test year level using the updated, September 30, 2005 escalation factors. This, it argues, is consistent with the five-year averaging methodology used for other accounts and removes the impact of abnormal cost levels. The result is DRA's recommended non-perchlorate related legal costs of $151,972, which is $135,824 less than the amount proposed by the company.

San Gabriel maintains that it requires outside counsel to assist in the assertion and protection of water rights, the pursuit of claims against those responsible for groundwater pollution and against governmental agencies for service duplication, defense against legal claims brought by others, and complex matters involving real property, easements, franchises, rights of way, company operations, and regulatory issues.

The president of the company testified that the variability of legal issues and of legal fees from year to year justifies San Gabriel's reliance on ten years' activity and legal expenditures, allowing a normalized projection of general legal expenses. He testified that in the first 11 months of 2005, the Fontana Division had incurred legal fees unrelated to groundwater contamination or this GRC that exceeds San Gabriel's test year estimate, and he expects the full-year cost for 2005 to be much higher than that estimate.

Outside legal expense is not as susceptible to forecasting as the more routine forecast of maintenance expense or payroll costs. Legal fees can come in chunks – high in one year, low in the next year. To provide for the possibility of high fees we will adopt San Gabriel's estimate, but to also provide for the possibility of average expense we will require San Gabriel to create a memorandum account to record outside legal expenses, capped at $287,795. Money not reasonably expended shall be returned to the ratepayers.

b) Perchlorate-related Legal Expenses

San Gabriel's witness testified that San Gabriel has spent considerable sums on legal representation to pursue its claims against groundwater polluters, including $939,000 in legal fees and expenses in 2003, $755,000 in 2004, and $558,000 in the first six months of 2005. He expects such legal fees to increase sharply due to complex litigation against polluters in the Fontana-Rialto area. San Gabriel has been a very active participant in the Inland Empire Perchlorate Task Force, which includes three other affected water purveyors in the Fontana, Rialto, and Colton area, state agencies, and specialized legal counsel, engineers, and consultants. He testified that much remains to be done to require the polluters to implement a clean-up of groundwater supplies contaminated with perchlorate. San Gabriel proposes to apply future recoveries in the WQMA and account for the investments as contributions for the benefit of ratepayers. Perchlorate related legal expenses are currently accounted for through the Water Quality Litigation Balancing Account and are not factored into base rates. DRA recommends that this methodology continue, and that amounts recorded in the Water Quality

Litigation Balancing Account continue to be deferred until the outcome of the associated legal expenditures and litigation are known.

7. Utilities and Rents Expense

San Gabriel's O&M expenses for TY 2006-2007 include $88,200 for Utilities and Rents, based on the actual 2004 amount, escalated to the test year level. Replacing the actual 2004 amount with the five-year average level (inflated to 2004 dollars) and escalated to TY 2006-2007 while using San Gabriel's proposed escalation factors results in a Utilities and Rents expense of $88,892. DRA's recommended amount for Utilities and Rents is $89,100. The difference between DRA's recommended amount and that proposed by San Gabriel is due to DRA's use of more recent escalation factors. San Gabriel agrees with DRA, as do we; it will be adopted.

8. Labor Costs

San Gabriel's filing included payroll expense for TY 2006-2007 of $5,061,200. In projecting payroll expense, San Gabriel began with the actual employee monthly salaries as of June 1, 2005. It added all vacant positions as of that date as though they were completely filled and added proposed new employee positions. The resulting amounts were escalated to TY 2006-2007 by applying the June 1, 2005 ECSB Compensation per Hour Index; many positions were also increased by step increases.

DRA 's recommended payroll expense for TY 2006-2007 is $4,516,000, a reduction of $545,200 from the company's filing. DRA made the following revisions to San Gabriel's calculations: (1) removed 11 vacant positions; (2) replaced the Compensation per Hour Index with ECSB's labor inflation rates published in September 2005; (3) removed the step increases; (4) replaced wages for newly filled positions with the actual salary amounts;

(5) removed five of the 12 proposed new positions; and (6) removed four additional proposed new Water Treatment Operator IIIs and recommended advice letter recovery for these four new positions.

In D.05-07-044, issued in San Gabriel's Los Angeles County division GRC, the Commission adopted DRA's preference for ECSB's labor inflation rates rather than ECSB's Compensation per Hour Index to forecast in-house labor expense. In that light, San Gabriel has agreed to use the ECSB labor inflation rates, thereby reducing its proposed revenue requirement for TY 2006-2007 by about $330,000, while also agreeing to apply the September 2005 version of the ECSB escalation factors. Consequently, the proposed DRA disallowance is $215,200.

a) Existing Positions

The payroll calculation used by San Gabriel in projecting the TY 2006-2007 payroll expense assumed that all existing vacant positions were filled. As of the date of the filing was prepared, San Gabriel had 13 vacant positions. As of November 14, 2005, 12 of the existing positions included in the filing were vacant. DRA recommends that the 12 positions that were vacant as of November 14, 2005 be removed in determining TY 2006-2007 payroll expense as it is normal to have some level of vacancies in any given period. In addition, for new employees that had been hired from the date of the company's filing through November 14, 2005, DRA replaced the projected salary included in the filing with the actual amount.

DRA's recommendation to remove the vacant positions is adopted. It is consistent with our decision in the recent Los Angeles Division rate case, D.05-07-044. In that decision, we did not include the vacant positions, indicating that adjustments should not be made for temporary vacancies absent a showing of extraordinary circumstances. The decision also indicated that most utilities will have vacancies and "to the extent there were vacancies in the recorded year, we should assume there will also be comparable vacancy savings in the test year and escalation years. (D.05-07-044 at p. 10.)

b) New Positions

In addition to assuming that all vacant positions would be filled by the start of the test year, the company has also included costs associated with 12 new positions. The new positions, along with the projected hire by dates included in the filing, are as follows:

- Safety Specialist (July 2006);
- Customer Serviceman (January 2007);
- Meter Reader (January 2007);
- Water Treatment Supervisor (July 2006);
- Six Water Treatment Operator IIIs (July 2006);
- Plant Maintenance Man A (January 2007); and
- Water Treatment Operator (July 2006). (Ex. 45, pp. 3-7; 3-8

DRA recommends that five of the proposed 12 new positions be removed, consisting of: two of the six proposed new Water Treatment Operator III positions; new meter reading position; new customer serviceman; and new Water Treatment Superintendent. For the remaining four Water Treatment Operator III positions that DRA recommends allowing, DRA recommends the associated costs be removed from the determination of the TY 2006-2007 costs and be allowed for recovery via advice letter after (and if) the Sandhill Treatment Plant upgrade is up and running and the positions are actually filled.

c) Water Treatment Operator III Positions

As of November 14, 2005, San Gabriel employed four Water Treatment Operator IIIs, plus two vacant Water Treatment Operator III positions. The California Department of Health Services (CDHS) requires the company to staff the Sandhill plant, after upgrades are complete, with two Water Treatment Operators with Grade III certification or above for 24 hours a day, seven days a week. The Sandhill plant currently is not staffed from 12:00 p. m., to 7:00 a.m., and on Saturdays and Sundays only one individual is employed for 8 hours each day. The Company explained that it needed the equivalent of 8.4 water treatment operators to maintain adequate staffing, in compliance with CDHS requirements on a "24/7" basis. To account for sick leave and vacation time, it requires ten operator positions for full staffing. DRA recommends that the costs associated with new Operator III positions be removed from base rates and recovered via advice letter after the Sandhill plant is in operation and the positions are actually filled. The Company has included these positions as though they were hired before July 2006, the start of TY 2006-2007. The company has indicated that the Sandhill plant upgrade will not be in service until August 2007, outside of TY 2006-2007. Thus, DRA argues the associated payroll costs should not be included in the TY 2006-2007. San Gabriel responds that the new water treatment operators are absolutely essential, and must be hired before the upgrades are completed in order to undergo necessary training.

If the Sandhill plant is running by August 2007, it is necessary to employ, train, and qualify all the operators prior to start-up. That training is expected to take three to six months. We see no reason to require an advice letter filing to recover these costs, but because the new employees will be working less than half a year in the test year we will disallow one position. Five additional Water Treatment Operator IIIs will be authorized.

DRA would disallow one meter reader position, one customer service position, and one water treatment superintendent because labor cost escalation should cover the increased payroll costs. Customer service and needed supervision are day to day questions particularly within the relationship of the company to its customers. We are not in the business of micro-managing Class A water utilities. DRA's recommendation is rejected.

d) Employee Step Increases

In addition to applying the ESCB's Compensation per Hour Index to the June 1, 2005 salaries, discussed in the following section, San Gabriel has included step increases for numerous positions. This results in a overstatement of labor expense. In the recent Los Angeles Division GRC (D.05-07-044 at p. 10.), the Commission determined that step increases should be removed. We will follow D.05-07-044 and eliminate step increases.

e) Escalation Factors

DRA reduced projected payroll expense for both existing and new employees by substituting ECSB's September 2005 Labor Inflation Rates for San Gabriel's use of ECSB's June 2005 Compensation per Hour Index. San Gabriel agreed to apply the more recent escalation factors, which we adopt.

9. Employee Pensions and Benefits

a) Vacation, Holidays and Sick Leave

San Gabriel proposed $828,000 for payroll expenses related to vacation, holiday, and sick leave. After applying DRA's recommended revisions to payroll costs, vacation, holiday, and sick leave expenses are reduced by $90,000. The company agrees with DRA. We will adjust it to reflect our adopted revision to payroll.

b) 401(k) costs

San Gabriel calculated $301,639 for 401(k) expenses for TY 2006-2007. The amount was calculated based on the estimated 2005 company contribution rate of 7.34%. DRA agrees San Gabriel's use of the 7.34% contribution factor is reasonable. We will change the escalation factor from the Compensation per Hour Index to the Labor Inflation Rate and recalculate the expense based on our adopted revisions to payroll.

c) Health and Dental Insurance

For health insurance expenses, San Gabriel inflated the 2005 premiums by an assumed increase of 14.19%; and for dental insurance expenses by inflating the 2005 premiums by an assumed increase of 6%. DRA agrees with San Gabriel's forecasts and methodology. We will modify the health and dental insurance expense to reflect the impact of our revisions to payroll.

10. Injuries and Damages

San Gabriel's projected TY 2006-2007 injuries and damages and property insurance expense is $626,600. This includes costs for an umbrella insurance policy covering general liability, automobile liability and property damages, and workers compensation premiums. Of the total $626,600,

$12,300 is for property insurance, $390,000 is for workers compensation insurance, and the remainder is for liability.

a) Business Property and Umbrella Liability Insurance

San Gabriel's filing includes $236,600 for non-workers compensation ($626,600 total amount - $390,000 for workers compensation) related injuries and damage costs, consisting of business, property, and liability insurance. In determining the costs associated with the umbrella insurance policy covering general liability, automobile liability, and property damages, San Gabriel's TY 2006-2007 estimate was based on the actual 2005 invoiced amount, escalated by 10% for 2006 and 2007. The 10% escalation rate is consistent with insurance cost escalations DRA's consultants have seen in recent years, and DRA finds the factor to be reasonable. DRA accepts San Gabriel's projected insurance costs.

b) Worker's Compensation Insurance

San Gabriel projects worker's compensation insurance premiums for its Fontana Division of $390,000 in TY 2006-2007, an amount which includes increases due to two factors: increased payroll and assumptions regarding its experience modification factor (Ex Mod).

The Ex Mod is a percentage factor applied to the determined premiums, which either raises or lowers the premium for individual companies. According to San Gabriel, its insurance broker calculated that San Gabriel's Ex Mod will increase from 83% to 92% effective July 1, 2005. This is an increase of 10.8%, which will increase the company's workers compensation insurance premium by the same percentage. In its calculations for the following plan year, the year beginning July 1, 2006, San Gabriel increased the Ex Mod factor to the full 100%. DRA claims that the 100% Ex Mod factor is inconsistent with actual experience for San Gabriel.

DRA recalculated the projected workers compensation insurance expense. First, DRA replaced the company's projected percentage increase in overall costs with the overall percentage of payroll cost increase recommended by DRA based on its payroll adjustments previously discussed. Second, DRA removed the company's projected Ex Mod factor of 100%, to reinstate the most recent Ex Mod factor of 92%. The result is a recommended TY 2006-2007 workers compensation insurance expense of $333, 600, which is $56,400 less than the amount proposed by San Gabriel.

Additionally, over each of the last three years, San Gabriel has received refunds of its workers compensation expense payments. These refunds have been flowed by San Gabriel to retained earnings and are not factored into the workers compensation expense calculation. The annual refunds for each of the last three years for the Fontana Division were $1,754 in 2005, $51,150 in 2004 and $17,988 in 2003. As ratepayers pay the costs of workers compensation insurance in rates, they should also receive the benefit of the refunds received by San Gabriel for such insurance costs. DRA recommends that the workers compensation expense be offset by the three-year average of refunds received, or $24,000.

A San Gabriel witness testified that for seven of the past ten years San Gabriel's Ex Mod factor has exceeded 100%. Because a 100% factor represents the statewide, industry-specific average loss rate in a given year, using a 100% Ex Mod is equivalent to normalizing workers compensation insurance expense – an appropriate approach for estimating test year costs.

We will modify San Gabriel's worker's compensation expense by adjusting for the payroll increase which we have adopted and by offsetting the expense by the three-year average of refunds received, $24,000. We will not adjust the Ex Mod factor as requested by DRA. For seven of the past ten years it has exceeded 100% for San Gabriel. Refunds should ameliorate the expense.

11. Regulatory Commission Expense

San Gabriel's filing includes TY 2006-2007 regulatory commission expenses of $191,400. Included is $187,333 for the amortization over three years of San Gabriel's projected $562,000 cost for this rate case. The $562,000 cost includes $390,000 for outside legal fees. DRA agrees with this expense and its amortization. It is adopted.

12. Uncollectibles and Franchise Fees

San Gabriel projects uncollectible expenses based on a five-year average uncollectible rate of 0.2850%. Considering the consistent annual decline in the uncollectible rate, DRA recommends the last two-year average be used in for determining uncollectible expense. DRA and San Gabriel have agreed to the use of a two-year average rate of 0.1951%. San Gabriel's originally proposed uncollectible expense was $123,600. DRA's recommended uncollectible expense, based on the DRA projected 2006-2007 revenues at present rates and DRA's proposed uncollectible factor of 0.1951%, is $85,800. DRA's recommendation is adopted, modified to reflect our projected revenue.

San Gabriel incorporated franchise fee expenses based on a five-year recorded average franchise fee rate of 0.8091%. DRA and San Gabriel have agreed that this rate is reasonable. It is adopted.

VI. General Office Allocation

The general office allocation consists of common expenses that are not directly assigned to an operating division. These costs are allocated between the Los Angeles Division and the Fontana Division based on a four-factor allocation formula. DRA accepts San Gabriel's allocation. It is adopted.

VII. Taxes

A. Income Taxes

The difference in income taxes estimated for TY 2006-2007 between DRA and San Gabriel are due to the differences in revenues, expenses, and rate base, and San Gabriel's failure to reflect the impacts of the American Jobs Creation Act of 2004 on its income tax expense.

The American Jobs Creation Act of 2004 provides for a deduction equal to 3% of qualified production activities income in 2005 and 2006 and 6% of qualified production activities income in 2007 and 2008. Under the Act, the production of potable water, including the acquisition, collection and storage of raw water, qualifies as a production activity to which the deduction is applicable. As the applicable deduction is 3% for 2006 and 6% for 2007, DRA utilized an average deduction rate for TY 2006-2007 of 4.5%. San Gabriel has estimated the percentage of its net income applicable to production activities to be 51.9%. DRA has reviewed these estimates and finds them reasonable.

The application of the 51.9% production activities factor to DRA's calculated taxable income at present rates, along with the application of the 4.5% average deduction rate, results in a $246,100 reduction to taxable income. In flowing through the impact of the 2004 Act, the 51.9% production activities factor should be applied to the ultimate taxable income for federal income taxes resulting from this case, with the average 4.5% deduction rate then applied to determine the production activities deduction for income tax purposes. This also impacts the net-to-gross multiplier, reducing the effective FIT rate to 34.18%.

San Gabriel disagreed with the application of this adjustment stating that the Commission should open an Order Instituting Investigation (OII) or Order Instituting Rulemaking (OIR) to analyze the tax legislation and IRS guidance for ratemaking purposes. DRA says the Company would have the Commission ignore this tax deduction and ignore the reduction in income taxes that will result until some unknown future date. DRA says this is neither reasonable nor appropriate. The 2004 Act is already in effect, was in effect for tax year 2005 and beyond, and includes the production of portable water as an item of qualified production income to which the deduction is applied. San Gabriel points out that the Commission did not apply the impacts of the 2004 Act in the Company's recent Los Angeles Division rate case (D.05-07-044), and that it should not deviate from its past precedent. D.05-07-044 is irrelevant in this instance. D.05-07-044 was based on TY 2004-

2005. The Act is in effect for TY 2006-2007 and is a benefit that is available to San Gabriel. We adopt DRA's recommendation.

DRA calculated tax depreciation for state and federal income tax by applying the ratio of DRA's estimate of net plant to San Gabriel's estimate of net plant, to San Gabriel's tax depreciation estimate.

In calculating the interest deduction, DRA used its recommended rate base, multiplied by DRA's recommended weighted cost of debt of 3.39%. The interest deduction is determined by applying the weighted cost of debt to the final rate base. The Company has agreed that this is the correct methodology. Since DRA has reached a settlement with the Company on the capital structure and rate of return, the resulting weighted cost of debt for TY 2006-2007 is 3.39% determined based on the average of the 2006 and 2007 weighted cost of debt presented in Joint Exhibit 85. In the Joint Comparison Exhibit, Exhibit 88, DRA's final position reflects the interest deduction based on DRA's recommended rate base and the settled upon weighted cost of debt of 3.39% for TY 2006-2007. DRA and San Gabriel are in agreement on the methodology for calculating the interest deduction for income tax purposes and on the weighed cost of debt rate to use. The only remaining difference is the rate base amounts to which the weighted cost of debt is applied.

B. Other Taxes

Taxes Other Than Income include ad valorem taxes (property tax) and payroll taxes. San Gabriel included in TY 2006 - 2007 $1,034,500 for ad valorem taxes and $491,800 for payroll taxes. DRA's recommended TY 2006-2007 ad valorem taxes are $766,200 and payroll taxes are $431,700.

DRA's ad valorem figure differs from San Gabriel's due to DRA's different rate base estimates, which are discussed later. Payroll taxes include

Social Security tax, Federal Insurance Contribution Act (FICA), Federal Unemployment Tax Assessment (FUTA), and State Unemployment Tax Assessment (SUTA).

DRA's recommended TY 2006-2007 payroll tax expense is $431,700, which is $60,000 less than the amount proposed by San Gabriel. DRA's recommendation flows through the impacts of DRA's recommended adjustments to payroll. San Gabriel and DRA agree on the amount for Other Taxes except for payroll. We adopt their recommendation but will use our independent findings on payroll.

VIII. Components of Rate Base

A. Current Water Supply System

1. Overview

San Gabriel (Fontana Division) serves approximately 43,000 customers with approximately 46,000 acre-feet per year. The system has 37 water production wells with a peak available production of 71 mgd, 12 storage reservoirs with an aggregate usable storage capacity of 28.4 million gallons, one water filtration plant (Sandhill) with a capacity of 17 mgd, and approximately 3,400,000 feet of distribution and transmission pipelines. It has a summer peak day demand of approximately 67 mgd and a fire flow storage requirement of approximately 2.5 millions gallons. It has been experiencing an average growth of approximately 1,300 new customers per year and expects this growth rate to continue.

Most of the controversy affecting rate base estimates concerns San Gabriel's planned investments in utility plant. Assessing the need for these investments depends on understanding the current water supply system serving Fontana Division customers and the extent to which utility plant additions are required to meet base load and peak demand both reliably and efficiently and in compliance with CDHS Safe Drinking Water Act requirements.

2. Water System Master Plan

The Fontana Division is confronted with increased demand throughout its service area as the result of rapid new development. Recognizing the need for an update plan to address the growing demands on its water supply and distribution system, in October of 2003, San Gabriel retained an engineering firm that specializes in water system design to prepare a comprehensive Water Master Plan. That Master Plan includes a water demand forecast model and a hydraulic water distribution system model as tools to analyze future system demands and corresponding infrastructure requirements. The analysis identified areas within the Fontana Division's service area that will require new sources of water supply, additional storage to provide operational flexibility and to provide for peak demands and/or fire flow requirements, and new booster plant facilities.

The Master Plan reviewed existing sources of supply and the ability to comply with current and proposed State and Federal drinking water requirements, including revisions to the Federal Safe Water Act, the Federal Unregulated Contaminant Monitoring Rule (UCMR), development of a Vulnerability Assessment, development of an Emergency Response Plan, the Disinfectant/Disinfection By-product Rule (D/DBPR), State UCMR, the Drinking Water Source Assessment and Protection (DWSAP) Program and the interim Enhanced Surface Water Treatment Rule (ESWTR).

The Master Plan addressed the rapid growth in the undeveloped northerly portions of Fontana Division's service area and additional industrial growth in the southerly areas, both of which will require additional water supplies to meet customer demands and increased fire flow requirements. The increased water demand in these areas will require new wells along with new reservoirs (for fire flow requirement and peak demand), booster pumps, and transmission and distribution pipelines to provide necessary flows at appropriate pressures.

According to the Master Plan, approximately 25 mgd of additional groundwater supply is needed by the year 2010 in order to meet increased demands and to increase the reliability of the system. The Master Plan recommends that the Fontana Division increase its water service reliability during emergency situations when wells are unexpectedly taken out of service. Emergency situations can include contamination and extended power outages, which can cause up to three wells to be placed out of service. The Master Plan recommends that the Company have redundant well capacity for at least three 2,000 gpm wells. The Master Plan recommends a total of eight new groundwater production wells (including three wells to provide redundant well capacity), each with a capacity of approximately 2,000 gpm, for a total capacity of approximately 16,000 gpm, be installed prior to 2010.

In the short term, the Master Plan includes budgeting for the installation of groundwater production wells, reservoirs, boosters, a complete Supervisory Control and Data Acquisition (SCADA) system, groundwater treatment facilities, and improvements to the Sandhill plant to maintain and improve water service reliability. The Fontana Division's most reliable source of supply is groundwater produced from the Chino Basin. Emphasis was placed on this source of supply to address anticipated water demands. A complete SCADA system will improve operation efficiency and reliability. Individual projects are discussed below.

The Master Plan concluded, among other things:

- That the Fontana Division has a current deficiency of 19 mgd under drought conditions, requiring construction of new and replacement wells that will produce at least 25 mgd as well as construction of a 7 mgd perchlorate treatment facility that will treat three contaminated wells, in order to overcome the current deficiency, meet year 2010 maximum day demands under drought conditions, and provide sufficient redundancy during emergency interruptions.

- That evaluation of required storage capacity to meet pressure and supply equalization, fire suppression, and emergency needs indicates current capacity shortages in the Baseline and Highland Zones, which will grow by 2010 to 4.5 mg and 1.4 mg, respectively.

- That construction of new reservoirs at six specified sites, some of which will provide backup when primary reservoirs are shut down for repair and maintenance, will overcome storage shortages projected for 2010 and will provide effective storage reliability in the Highland, Baseline, and Alder Zones.

DRA recommends that: costs for seven of the eight requested new wells be disallowed along with the associated plant additions; five of the nine requested new reservoirs be disallowed along with the associated plant additions; the Sandhill plant project costs included in plant by San Gabriel beginning in 2005 be removed from plant; the 2008 perchlorate treatment costs be excluded from Company funded plant and included in plant when it is known and measurable as contributed plant; and the proposed cost for mains be adjusted to reflect an historical level of expenditures.

The basis for DRA's recommendation is that "the Company's request for additions to plant appears to be structured on the Company's need to meet its peak day demand. While the Company must have sufficient resources to meet it peak day requirements, it is not appropriate for ratepayers to fund facilities to produce that requirement on a daily basis. A system that produces the peak day demand would have excess capacity that is not used and useful to ratepayers over the rate period. Alternative sources of supply, such as the outside purchases and emergency purchases relied on in the past, should be incorporated in the Company's forecast." (DRA Opening Brief, 37-38.)

DRA notes that the Company's Master Plan estimates a peak demand requirement of 73.8 mgd, which is well in excess of the 2005 peak demand of 66 mgd. Based on the Master Plan, the available supply from wells was 59 mgd, to which DRA adds the wells back in service that increase supply by 17.4 mgd, plus 2.9 mgd for the well which DRA recommends be allowed, resulting in a total supply from wells alone of approximately 79.3 mgd. This supply from wells does not include the supply from Lytle Creek flow or purchases. The supply exceeds the Master Plan requirement of 73.8 mgd by 5.5 mgd. DRA concludes that the Company's supply is sufficient to meet its requirements at this time. Thus, seven of the eight additional wells requested and the upgrade to the Sandhill plant are currently not required.

The District asserts that the Company's own evidence shows that it has sufficient capacity to adequately serve all its customers. Further, growth can be accommodated by adding one well a year. Therefore, the maximum expansion which can be justified for the three years involved with this GRC is three wells. The District says that the current well capacity of San Gabriel equals 87.83 mgd and the entire water production capacity totals 100 mgd. The largest maximum demand for any single day is 66 mgd. San Gabriel expert witness testified that the system should have a redundancy factor added to peak demand to accommodate wells lost to drought, electrical outages, etc. He recommended 8.6 mgd. Therefore, the total capacity needed to serve the existing customers is 74.6 mgd. Consequently, San Gabriel already can meet its current demand of 66 mgd and still have a reserve of 34 mgd.

The City supports the water supply system analysis of the District. The City emphasized that San Gabriel's proposed system upgrades of $89,500,000 would be in addition to the current rate of about $71,000,000, which would create an intolerable burden on the ratepayers, especially the residential ratepayers.

B. Plant Additions

San Gabriel calculated utility plant in service for TYs 2006-2007 and 2007-2008 based on construction budgets, estimated advances for construction, contributions in aid of construction (CIAC), and items to be retired. The construction budgets include provisions for several capital projects which are expected to improve the system's ability to meet customer demands for safe, reliable water service, consistent with the guidance provided by the Water System Master Plan. These projects include plans to construct eight reservoirs and eight new wells over the next four years at strategic locations within the service area as well as upgrade of the Sandhill plant to allow it to treat SWP water and to enhance its capacity to treat water from Lytle Creek.

The calculations of proposed test year utility plant in service exclude investments after 2005 in two projects, the Sandhill plant upgrade project and the new headquarters complex, which are proposed to be added to rates by advice letter. These additional investments in utility plant and their proposed ratemaking treatment are discussed in the context of each project below.

The forecasted company-funded capital expenditures are $28.3 million in 2005, $28.3 million in 2006, $18.5 million in 2007, and $14.7 million in 2008. (Ex. 9, p. 20.) San Gabriel expects to meet its capital budget requirements by a combination of internally generated funds, bank borrowing, and new mortgage bonds.

1. Sandhill Surface Water Treatment Plant

The Sandhill plant is a "diatomaceous earth filtration system for surface water" that began operation in 1965. The plant relies on surface water diversions from Lytle Creek but often must be shut down and is unable to use that surface water during (and often for months following) storms and periods of heavy snow melt, when Lytle Creek has high levels of turbidity that exceed the current treatment capability of the Sandhill plant. The other source of supply for the Sandhill plant is State Water Project (SWP) water that must be blended with Lytle Creek surface water before it can be treated. These blending requirements restrict the capacity of the Sandhill plant to the availability of useable Lytle Creek surface flow. The Sandhill plant must be operated in compliance with increasingly stringent State and Federal safe drinking water regulations, including regulation governing Cryptosporidium, Giardia, and byproducts of the disinfectants used to control those organisms.

a) History and Description of the Sandhill Project

Prior to 1960, the only treatment provided for Fontana Division's surface water supply from Lytle Creek was at Fontana Union Water

Company's (Fontana Union) afterbay, where screens removed large debris such as twigs and moss, and water was chlorinated as it entered a Fontana Union transmission pipeline. In 1960, San Gabriel joined with Fontana Union to build a surface water treatment facility including a microstrainer and chlorination facilities owned by San Gabriel. Upon notification by CDHS in 1962 that the microstrainer provided inadequate treatment, San Gabriel selected diatomaceous earth (DE) filtration as a replacement and in 1965 completed installation of a 10 mgd DE surface water filtration treatment plant, later expanded to 20 mgd, which CDHS approved in1968 as adequate for treating Lytle Creek surface water but not SWP water.

After several years' operation, the limited capacity of DE filtration to deal with high turbidity became apparent. The passage of clay through the DE filters caused effluent turbidity to rise to the maximum level permitted under Federal and State regulations, making it necessary under such circumstances to shut down the plant. The required shutdown of surface water processing through the Sandhill plant has deprived the Fontana Division of thousands of acre feet of low-cost surface water, including over 25,000 acre feet just in the first five months of 2005.

In 2002, laboratory tests showed that clay can easily be reduced or removed by a pretreatment process of coagulation, flocculation, and sedimentation, making the Lytle Creek surface flows filterable under high turbidity conditions. These factors, plus the fact that thousands of AFY of available low-cost surface are lost due to clay, led San Gabriel to design and install upgrades and modifications to the existing DE treatment process to add the necessary pretreatment facilities.

CDHS has authorized San Gabriel to treat SWP water at the Sandhill plant, but with the restriction that the untreated SWP water must be blended with Lytle Creek surface water at a ratio not exceeding 80% SWP water and not less than 20% Lytle Creek water.

The result is that when Lytle Creek flows are low, particularly during summer months when the demand for water is greatest, the company can only treat correspondingly small quantities of SWP water. Even when rainfall is ample, the Lytle Creek flows are often unusable, due to excess turbidity, and, although the Sandhill plant's theoretical rated capacity is 20 mgd, its useful capacity is reduced to a maximum of about 17 mgd because the backwash cycle requires taking filters off-line and using a substantial amount of water for that function.

The planned upgrades and pretreatment facilities will permit the Sandhill plant to treat 100% Lytle Creek surface water, 100% SWP water, or any blend of the two. This will restore the full usefulness of the Sandhill plant even when Lytle Creek surface water is unavailable or too muddy, because the plant will be able to process SWP water.

The Water System Master Plan recommends modifying the Sandhill plant to eliminate the need for blending, to expand plant capacity from 17 to 29 mgd, and to obtain additional access to SWP water, in order to allow San Gabriel greater flexibility in managing its water supply sources both in the short and long term. The San Bernardino Valley Municipal Water District (Muni) has agreed to increase its commitment to provide SWP water to the Fontana Division from the current allowance of 3,000 up to 5,000 AFY, and that IEUA also has committed to provide SWP water for use at the Sandhill plant once the planned upgrades are completed.

b) Evaluation of Need and Cost Effectiveness

San Gabriel expects the construction contract for the Sandhill plant upgrade project to cost approximately $35 million, to which must be added staffing and maintenance.

San Gabriel's cost-benefit analysis indicates that the Sandhill plant upgrade project will pay for itself in two years. Among the project's significant benefits is that additional water supplies are made available in the northern portion of the system, closer geographically to customer demands and readily transported by gravity, which will allow San Gabriel to reduce the quantities of far more costly Chino Basin supplies having to be boosted to higher elevations in the distribution system at substantial energy cost.

DRA argues that the company's own witnesses do not agree whether the supply can be relied on the in the summer to meet peak demands and there are no formal contractual commitments for providing additional supply. Supply exists to meet the average requirements and if the Sandhill plant cannot provide supply to meet peak demands, there is insufficient justification to allow the addition in rates. DRA recommends the advice letter treatment be denied and the cost and used and usefulness of the plant determination be deferred until the next GRC.

DRA says that San Gabriel's testimony indicates that the plant start-up date is August of 2007. The plant is not used and useful in 2005, won't be used and useful in 2006, and may be used and useful in late 2007, which is after the TY 2006 - 2007. In D.04-07-34, San Gabriel requested that it be allowed to upgrade the Sandhill plant at an estimated cost of $9.8 million. In two years the cost has escalated to $34 million, a phenomenal increase in a time of low inflation.

DRA's primary concern with San Gabriel's proposed Sandhill plant upgrade is that San Gabriel has reflected $12 million of the estimated $35 million cost in plant in service and is proposing to collect the remaining $23 million through advice letters. As an alternative, DRA recommends that the projected $12,000,000 of cost in 2005 be removed from plant. The plant upgrade will not be in service in 2005. The next GRC is the proper time to make a determination whether the final cost is appropriate and to determine the actual increase in capacity that will occur as a result of the upgrade.

The Sandhill plant's primary function will be a baseload unit, operating as nearly as possible on a 24-hour, seven-days-per-week basis to make maximum possible use of San Gabriel's most economical sources of supply- Lytle Creek surface water and SWP supply purchased through Muni. Delivering those economical supplies into San Gabriel's distribution system near the highest point in the Company's service area not only will maximize use of inexpensive supplies, but also will minimize the cost of power for pumping water to the point of use.

The most difficult issue to resolve regarding the Sandhill plant project is how the cost should be passed into rates. DRA proposes to disallow rate base treatment of investments already made until San Gabriel's next GRC three years from now. San Gabriel's proposal would allow rate base treatment of the year 2005 investment while reflecting succeeding years' investments in rates advice letter filings effective January 1, 2007, 2008, and 2009.

We believe the most equitable way to provide recovery in rates is to continue the solution found reasonable in D.04-07-034 to limit rate base growth to 10% per year. (D.04-07-034, p. 66.) We are not disposed to dictate to San Gabriel which plant will be constructed in which order; that is a management decision. We will resolved "used and useful" issues in its next GRC, at which time a major concern will be whether the Company has maximized its efforts to obtain contributions from developers and others to pay for plant needed to meet growth.

2. Wells

The Water System Master Plan recommends construction of a total of eight new Chino Basin wells located to provide supplemental water to specific pressure zones to help meet fire flow requirements and peak demands. The new well at Plan F7 is required to meet projected increased customer demand and fire protection requirements within the baseline pressure zone. The Master Plan recommends that four existing wells be replaced based on advanced age and remaining service life projections. The wells are at least 75 years old.

San Gabriel's proposed construction plan differs slightly from the Master Plan. It proposes to construct eight wells over the next four years, seven in the northern and western portions of the service area where additional supply is needed and one in the southern portion to replace an existing damaged well. These plans encompass seven of the eight new wells recommended by the Master Plan. San Gabriel plans for only one of the replacement wells called for by the Master Plan to be drilled in 2007.
San Gabriel said it needs these new wells to provide the ability to pump into reservoirs now under construction, which will enhance San Gabriel's ability to provide effective disinfection and to adjust flows from the reservoirs into the distribution system in accordance with customer demands, and to provide water for fire suppression purposes without causing an abrupt pressure loss or water.

DRA says that the Company's request to add eight wells is based on the perceived need for additional supply, which DRA claims is not needed. DRA recommends that only one well, constructed in 2005, be allowed in rates. DRA points out that in A.02-11-044, the Company requested and was allowed three wells that were not put in service as projected in 2003 and are again being requested in this case. According to the Master Plan, the water demands under normal weather conditions are estimated to be 54,000 AFY in the short-term (2010), while the production available as of April 11, 2005 was 66,246 AFY. DRA concludes that the current system has sufficient supply to meet and even exceed the projected short-term needs of 54,000 AFY without the added supply from surface water and emergency purchases. DRA recommends that only one well be allowed in rates at this time. The removal of the seven wells reduces plant by $700,000 in TY 2006-2007, and $700,000 in Escalation Year 2007-2008.

We have discussed San Gabriel's need for new facilities, which includes new wells and other plant. The issue is not need, but who pays. It is apparent that the need is clear and timing is important. Facilities take time to construct, test, and train staff to operate. Meeting 2010 requirements requires starting now. Because new wells are needed to meet the demands of new customers, those new customers should be contributing to provide the plant necessary to serve them. San Gabriel has planned well to provide a first class water system, but sadly lacks a first class plan to pay for it without beggaring its current ratepayers.

3. Wellhead Treatment Facilities

The Master Plan recommends installing a treatment facility at Plant 25 to remove perchlorate from groundwater produced at three wells in close proximity to each other, all of which are currently contaminated above the notification level of six micrograms per liter. The Master Plan recommends use of the same resin-based ion exchange process (which is best available treatment technology) presently in use. San Gabriel plans to construct the wellhead treatment facility in 2008.

DRA is concerned that the Company's requested addition in 2008 of the treatment facility, ignores the fact that the cost of the facility should be borne by the parties responsible for the contamination. DRA says that in A.02-11-044, San Gabriel contended that it could not put on hold the construction of treatment plants while waiting for litigation proceeds because it urgently needed the restoration of lost production capacity.

DRA argues that the Commission approved the Company's request for seven facilities in A.02-11-044, but no facilities were constructed. DRA submits that San Gabriel's conception of urgency varies from the ordinary sense of the word. How can the Commission be confident it will actually build the facility in 2008 when it failed to do it over the past three years despite the alleged exigency of restoring this source supply? DRA recommends the $2,000,000 of cost for the treatment facility be removed from plant additions because the cost is projected far enough into the future that we can determine the responsible parties' obligations prior to its in-service data. The cost of this project should be reflected as contributed plant if the plant is ultimately constructed.

DRA has not carefully read D.04-07-034. In that decision, we <u>did</u> <u>not</u> approve a request for seven facilities. What we did do was impose a rate base cap and said:

> "10. San Gabriel needs flexibility within the rate base cap to make its own decisions about the need for and timing of

> projects, and to make changes and substitutions as necessary to its proposed construction program." (D.04-07-034, Finding of Fact 10 p. 66.)

We do agree with DRA that the costs of this facility should be treated as CIAC, if the company recovers funds from its contamination lawsuits. But, in the meantime, the facilities are needed and should not be delayed pending the outcome of litigation. Preliminarily, costs should be recorded in construction work in progress (CWIP).

4. Reservoirs

San Gabriel plans to construct eight new reservoirs over the next four years at strategic locations to improve system reliability, provide needed storage for operating, emergency, and fire fighting purposes, and to increase storage capacity in each of the Company's five pressure zones. Two of these projects were planned for construction during 2005. Three are planned for 2007 and three for 2008. Water stored in reservoirs is used for normal operations and to satisfy peak demands and fire flow requirements that otherwise would need to be provided from additional wells and booster facilities. The Master Plan identifies several portions of the service area that may be vulnerable in the event existing storage facilities are not available due to maintenance needs or shortage of supply. The Master Plan recommends that new reservoirs be added in the Baseline, Highland, and Alder pressure zones. New reservoirs are needed to serve proposed new wells. New reservoirs are needed in the now-developing northern portion of the Fontana Division service area. New residential development will require greater reliance on reservoir storage at this location.

DRA recommends that three of the eight proposed reservoirs not be allowed in rates. DRA would reduce TY 2006-2007 plant by $727,500 and

TY 2007-2008 plant by $1,527,000. DRA's recommendation rests on its perceived lack of need for additional capacity. DRA reasons that according to the Master Plan, San Gabriel currently has 30.28 mg of useable storage capacity. Based on the requirements for equalization, fire suppression, and emergency, the Company's total storage requirement is 22.65 mg. By the year 2010 and 2025, the projected requirement is expected to be 24.81 mg and 31.12 mg, respectively. The current existing capacity exceeds the current and short-term needs of the Company and is approximately 1 mg short of the long-term requirements. DRA believes that the addition of the requested reservoirs and other facilities is excessive and could be related to future growth. To the extent that any addition to plant is growth-related, the cost of the added facilities to serve that growth should be contributed by developers.

We have previously discussed our reasons to accept San Gabriel's proposed improvements to its water system. The remaining issue is source of funds. We believe San Gabriel has neglected to emphasize developer funds to provide new facilities for new customers. The need for reservoirs arises not only to serve current ratepayers, but also to serve new. We agree with DRA that new customers should contribute new facilities. We need not decide at this time which facilities will serve new customers. In San Gabriel's next GRC, we can sort that out. We are confirming our plant increase allowance of 10% per year, but we will review which part of that 10% was investor funds and which part was, or should have been, contributed.

5. Other Facilities

San Gabriel requests that we should approve rate base amounts that include projected investments in booster stations, security equipment, emergency generators, and transmission mains associated with the wells and reservoirs that may be constructed.

DRA would disallow the equipment associated with the wells and reservoirs which it recommends be disapproved. We prefer to allow San Gabriel to choose the facilities it deems necessary under our rate base cap. We note that DRA has no objections to the SCADA system and security equipment San Gabriel expects to install.

6. Cucamonga Connection

The Fontana Division currently has two emergency interconnections, with a total capacity of 2,500 gpm, with the Cucamonga Valley Water District (CVWD) to provide water during emergencies and water system outages, but the ability to use these interconnections is limited. The Master Plan recommends installing a replacement 10,000 gpm interconnection to maximize deliveries during emergencies. San Gabriel explained that an improved emergency interconnection with CVWD will provide an alternative source of water to the elevated Hunters Ridge portion of the service area, and will help meet potential fire fighting demands during emergencies that may cause shortages in other sections of the Company's water system. San Gabriel has arranged for CVWD to design a 10,000 gpm connection and has budgeted $2.2 million in 2007 for installing 8,800 feet of pipe and a booster station to deliver water from CVWD. DRA reluctantly considered a $2.2 million investment in the CVWD emergency interconnection to be reasonable, and included it as a rate base addition. DRA's concern is that the connection cannot be relied upon during peak summer days when CVWD's demand also peaks. We do not share

DRA's concern. The connection is not expected to meet peak demand, but to meet emergency demands on San Gabriel's system.

7. New Office and Operations Center

a) Purchase of Land from Affiliate

San Gabriel has planned the construction of a new office/warehouse for its Fontana operations. DRA toured the current facilities which will be replaced by the new complex and agrees that a new facility will provide a more conducive work environment. DRA is concerned about the acquisition of the property. First, San Gabriel acquired the property (4.811 acres) for the new facility, on December 30, 2004 for $1,102,233 from Rosemead Properties, Inc. (Rosemead), an affiliate company of San Gabriel. The acquired parcel was part of an 8.72 acres parcel originally acquired by Rosemead on July 8, 2003 for $1,148,272. DRA recommends that the cost of the land acquired for the office building be reduced based on the cost paid by San Gabriel's affiliate Rosemead.

San Gabriel's witness calculated the purchase price of the property for Rosemead to be $126,000 per acre and the price to San Gabriel for the property to be approximately $234,000 per acre. The witness testified that an independent appraisal showed the property appreciated that much in a year and a half. He testified that Rosemead bought the land to hold for investment, and that San Gabriel purchased the land from Rosemead because the land suited San Gabriel's needs. He said that San Gabriel's personnel went through a long process to determine whether the Rosemead property was a site that made sense for San Gabriel's offices. Rosemead cooperated with San Gabriel in ways that a third-party seller would not have done selling San Gabriel the exact amount of land needed for its facilities and in the configuration San Gabriel required.

We will allow $591,250 in rate base calculated on the ratio of the size of the parcel Rosemead sold to San Gabriel to the size of the larger parcel of which it was a part. The parcel size and cost are not crystal clear on the record, but the evidence persuades us that the parcel San Gabriel purchased was 4.75 acres (San Gabriel O.B. p. 85); the Rosemead purchase was 8.72 acres (Ex. 23); the Rosemead price was $1,075,000. (Tr. p. 282, L.5.) We find that San Gabriel should have been charged 55% of $1,075,000, or $591,250 for the land.

This violation of the affiliate transaction restriction is particularly egregious. Rosemead is owned by United Resources, Inc. (United Resources). United Resources also owns San Gabriel. Rosemead purchased the property during the time that San Gabriel was seeking land on which to construct a new office building. The land was expected to go into rate base. When the land was sold by Rosemead to San Gabriel in December of 2004 it occurred during a process characterized by San Gabriel's vice president:

> "Q. Well, there wasn't really any negotiation, was there?
>
> A. Well, its essentially the same parties, so there's not negotiation per se, but the – well, no, there was not negotiation." (R.T. 284, L 22-26.)

The purchase agreement on the part of the seller was signed by R. H. Nicholson, Jr., the President of Rosemead and the Chairman of the Board of San Gabriel. The purchase agreement on the part of the buyer was signed by Mike Whitehead, President of San Gabriel. Mr. Whitehead reports to Mr. Nicholson.

b) Construction Expense

San Gabriel estimates that cost to construct the new facility will be $6,000,000 and that the cost be included in rates through an advice letter. DRA disagrees.

The proposed new office complex of $40,658 square feet is approximately twice the size of the six facilities (20,827 square feet) it is designed to replace. San Gabriel maintains that it still needs to retain a building on the existing site for a satellite customer service office. The new office complex includes approximately 11,548 square feet of office and general space for employees that previously occupied 4,719 square feel of space.

In its last rate case, A.02-11-044, San Gabriel first requested $3 million for the construction of a new office, and later during the proceeding increased to $6 million. The Commission deferred the request to this GRC filing. The decision stated that if the Company were to request authorization to proceed with the new building, it should provide complete justification for the building and it should address the ratemaking treatment of the proceeds from the sale of the existing facilities. (D.04-07-034, p. 40.) DRA contends the Company has not addressed the ratemaking treatment for the existing facilities as ordered or even committed to disposing of the existing facilities.

DRA argues that the proposed facility is excessive when compared to the facilities to be replaced; the $6 million request exceeds the $4.9 million cost to refurbish the existing facilities; the Company has not provided any justification for the cost of the new office/warehouse; nor has it addressed the ratemaking treatment for the existing facilities or committed to their dispositions.

DRA recommends that 50% of the proposed cost of $6 million be phased into CWIP during the years 2006 and 2007. San Gabriel should also be required to dispose of the facilities that are to be replaced via an arms-length transaction to an unrelated third-party, with the benefit of the sale going to ratepayers. For ratemaking purposes, the recommended amount for the new facility should remain in CWIP to allow the Company an opportunity to earn a return on the cost of the portion of the facility that may be found to be used and useful. In its next rate case, costs should be reviewed for prudence and the facility's size evaluated to determine whether the entire facility is used and useful. All gains derived from the sale of the existing facilities should be returned to ratepayers by offsetting the cost of the new facilities.

We agree with DRA. While we do not doubt that more office space is needed by San Gabriel, it has not convinced us that its proposed size is reasonable. We are also concerned about the disposition (or lack thereof) of the existing facilities. We would expect that the proceeds from the sale of the exiting facilities would be offset against the cost of the new facility. Any delay in the sale could raise questions.

c) Construction Work in Progress (CWIP)

CWIP is reflected in rate base as a means of allowing the utility to recover the financial carrying cost of investments in capital projects before they go into service. In the present circumstances, the Fontana Division's recent year-end CWIP balance is higher than normal, due to major projects the Company has under construction. The Company utilized the CWIP balance as of December 31, 2004 in each rate year. The December balance was higher than the historical CWIP balance because of the major projects currently being developed, which included the Sandhill plant modification, the new office complex, and the SCADA system. DRA points out that each of the projects included in CWIP are projects the Company has included in its requested plant additions. DRA believed inclusion of the cost in CWIP and in plant represents a double count of a portion of the requested plant costs.

The Company has estimated $7,700.4 million for CWIP for TY 2006-2007 and the same for TY 2007-2008. DRA has estimated an average of $5.5 million for TY 2006-2007 and $6.6 million for TY 2007-2008. (Ex. 45, 8-24, 25.)

The rate base cap of 10% includes plant in service plus CWIP. The capital budgets on which San Gabriel based its calculations of plant additions reflects only amounts to be spent in calendar years since 2004, the year upon which current rates are determined. We would expect a higher CWIP for TY 2006-2007 because of the major projects under construction. We find that the Company's CWIP is probably low, but reasonable.

d) Materials and Supplies

San Gabriel determined its projected material and supplies by calculating a five-year average of historical materials and supplies in 2004 dollars. The Company then increased the average for the percentage increase in plant projected and the non-labor inflation rate. DRA disagrees with San Gabriel's calculated projection because the application of the growth rate in plant is not justified. The average plant balance increased approximately 10% in 2004, but the average materials and supplies decreased by approximately 16%. The average plant balance in 2003 was approximately 11% higher than 2002, and the average materials and supplies for 2003 was approximately 3% higher than 2002. DRA asserts San Gabriel's growth factor is not justified. (Ex. 45, p. 10-3.)

DRA recommends that the five-year materials and supplies balance be adjusted for inflation only, using the updated inflation factors previously discussed. DRA's recommendation results in a reduction to the Materials and Supplies included in rate base of $238,300 in TY 2006-2007 and $326,200 in Escalation Year 2007-2008. (Ex. 45, pp. 10-3 – 10-4). The resulting Materials and Supplies balance to be included in rate base is $766,300 in TY 2007-2008 (Ex. 45, pp. 10-7 and 10-8).

San Gabriel disagreed with DRA's position, discounting DRA's emphasis on variations over a single year. San Gabriel emphasized that the materials and supplies balance increased by 56% over the last five recorded years, while utility plant increased by 48%, demonstrating a strong relationship between the rate base balances for utility plant and materials and supplies. We find reasonable San Gabriel's forecast method for materials and supplies, reflecting plant growth as well as general inflation (using updated inflation factors).

C. Contributions and Advances

1. Advances for Construction

San Gabriel reflected in its plant balance the same amount of advances for construction that are being reflected in the projected advance credit balance that offsets rate base. The additions to the advance account for the past five years averaged $3 million. The additions projected for 2005-2008 average $2 million. DRA accepts San Gabriel's estimate, but comments that the Master Plan attributed the additional plant requirements to growth in the Fontana Division. The growth that creates the need for additional plant should be either advanced or contributed by developers. We agree with DRA's comment. The advance estimate is reasonable.

2. Contributions in Aid of Construction

San Gabriel reflected the same amount of contributions that are being reflected in the projected contributions credit balance that offsets rate base. The additions to the contributions in aid construction for the past five years averaged $1.3 million. The Company's additions projected for 2005-2008 average $850,000. Historically, the $1.3 million represented approximately 11% of the $11.677 million average of gross plant additions. The projected $850,000 average for contributions is approximately 5% of the $18.379 million average plant additions estimated for the years 2005-2008. The difference between the actual and the estimates suggests that San Gabriel understated the projected contributions. We will adopt the historical average for contributions of $1.3 million. We do not understand how San Gabriel can project above average increases in plant while predicting a lower rate of CIAC. It appears the Company is maximizing its investment, which earns a return, rather than seeking contributions, which do not.

D. Working Cash

There are two main elements to the calculation of a working cash allowance: an operational cash requirements and a lead-lag study.
San Gabriel's witness testified that San Gabriel prepared the working cash component of rate base consistent with the method used by the Commission in prior rate cases. The witness explained that San Gabriel's method of calculating the working cash allowance complies with the detailed basis for computing revenue lag and expense lead/lag as stated in the Commission's

Standard Practice U-16. He summarized the minimum balances comprising the operational cash requirement.

DRA objected to several aspects of the Company's working cash calculations. DRA claimed to find an understatement in San Gabriel's lead-lag study of the lag for power costs. Reviewing San Gabriel's bills from Southern California Edison Company (SCE), DRA used a weighted average payment lag of 33.8 days as compared to 19 days used by the Company. DRA also criticized San Gabriel for ignoring working cash on hand not supplied by shareholders, including taxes collected for advances and contributions, advances not yet reflected as rate base offsets, and pending refunds. DRA contends that these adjustments justified a $6,595,574 reduction in San Gabriel's working cash – producing a negative working cash allowance of ($5,717,074).

Standard Practice U-16 does not mandate a single methodology for calculating working cash. Rather, it "serves a guide to the staff engineer or analyst" based on current staff practices that the engineer or analyst should consider in determining the working cash allowance. Standard Practice U-16, Paragraph 8 under Section D – Working Cash Component of Rate Base states, "for practical reasons, the method of determining the working cash allowance varies with the size, nature, and the operation of the utility."

Regarding the lag days for power costs, San Gabriel's witness explained SCE issues one monthly invoice to San Gabriel for facilities that are read on many different meter reading cycles. San Gabriel is billed and makes payment on a single 30-day billing cycle, to which the Company's 19-day lag calculation applies. He said San Gabriel calculated the Operational Cash Requirement by a simplifying convention consistent with the purpose of the working cash allowance and approved in past GRCs, including minimal cash balances required to be maintained in its customer service office cash drawers, petty cash, minimal balances in its regular checking and return checking bank accounts, and one-half of its postage account maintained at the post office. The total of these items was $26,000.

Responding to DRA's assertion that San Gabriel's working cash calculation ignores non-investor supplied cash. He explained that Standard Practice U-16 provides for calculating an Operational Cash Requirement as well as deductions from the Operational Cash Requirement, and that it would be consistent with the Standard Practice U-16 to combine the Operational Cash Requirement from which those deductions are taken. The witness testified that DRA's results "grossly understate the Operational Cash Requirement."

We agree with San Gabriel's working cash estimate. It was done in accordance with Standard Practice U-16. DRA has completely misconstrued Standard Practice U-16; DRA has ignored the Operational Cash Requirement. Negative working cash in the millions of dollars makes no sense. We have discussed this in detail in our recent discussion (D.06-07-____) in the rehearing of D.05-08-041 in A.02-11-044. San Gabriel's estimate is adopted.

E. Depreciation

San Gabriel's depreciation reserve, accruals, and expense for recorded years 2000 through 2004, estimated year 2005, and TYs 2006-2007 and 2007-2008 were accepted by DRA subject to differences regarding estimates of utility plant in service and advances during the relevant years, and subject to correction of a mathematical error in San Gabriel's calculation of Net Plant Retirements. We adopt the same methodology in determining the depreciation expense based upon our adopted estimates of Utility Plant.

IX. Cost of Capital

The cost of capital for a public utility typically is expressed as an overall rate of return, calculated by adding the weighed costs of long-term debt, preferred stock, and common stock equity. Because San Gabriel has no preferred stock outstanding, its capital structure includes only the two factors of long-term debt and common equity. During the evidentiary hearings, San Gabriel and DRA achieved a stipulation as to the capital structure, cost of debt, return on equity (ROE) and overall rate of return for purposes of this GRC, agreeing on an ROE of 9.90%, and overall rate of return of 9.33% for TY 2006-2007 and 9.35% for TY 2007-2008. The City did not join the stipulation.

A. Capital Structure

DRA's expert witness proposed an imputed capital structure, consisting of 40% long-term debt and 60% common equity, an equity ratio approximately half way between the average equity ratio of a group of small water utilities and San Gabriel's actual equity ratio. This was accepted by San Gabriel. The City's expert witness recommended an imputed capital structure consisting of 50% debt and 50% equity, based on a proxy group of water utilities which had a five year average debt/equity ratio of approximately 50/50. We have addressed this issue in the last two GRC decisions for San Gabriel, D.04-07-034 in the last Fontana Division case and D.05-07-044 in last year's Los Angeles County Division GRC. In both decisions, we adopted a hypothetical capital ratio of 60% common stock equity and 40% long-term debt. Having adopted a 60/40 ratio in 2004 and 2005, we are disinclined to depart from that ratio absent compelling evidence. We adopt the stipulation between San Gabriel and DRA.

B. Effective Cost of Long-Term Debt

The stipulation between the DRA and San Gabriel results in a cost of long-term debt for each year, 2006 through 2008, based on the amounts proposed by San Gabriel. The agreed upon long-term debt rates are: 8.44% for 2006, 8.49% for 2007, and 8.54% for 2008. The City's expert supported using San Gabriel's historical issuance cost of debt, calculating overall interest costs of 8.33% to 8.36%. He adjusted downward the estimated issuance expenses on San Gabriel's planned debt issues. We are not convinced bond costs will be as low as the City's witness has estimated. We adopt San Gabriel and DRA's stipulated amounts.

C. Cost of Equity

Equity cost is a direct measure of the utility's after-tax ROE investment. Its determination is based on subjective measurement, and is not susceptible to direct measurement in the same way as capital structure and embedded long-term debt costs. The quantitative models commonly used as a starting point to estimate investors' expectations are the discounted cash flow (DCF) and risk premium (RP). Although the parties agree that the models are objective, the results are dependent on subjective inputs. For example, each party used different proxy groups, growth rates, and calculations of market returns. Detailed description of the DCF and RP models are contained in the record and are not repeated here.

San Gabriel's expert witness presented an analysis of its cost of equity financing developed from a range of estimated equity costs for a sample of water utilities and gas utilities. The range of estimated equity costs resulting from the water utilities sample was from 10.3% to 11.6%, while the overall range of estimated equity costs for San Gabriel was from 11.5% to 12.8%, supporting a recommended 12.0% ROE. San Gabriel's own recommendation was an ROE of 11.5%. DRA originally proposed an ROE of 9.0%, while the City proposed an ROE of 8.9%. San Gabriel and DRA agreed to jointly support a ROE of 9.9%. Consistent with a 9.9% ROE, San Gabriel and DRA also jointly proposed to set the overall rate of return for TY 2006-2007 at 9.33% and for TY 2007-2008 at 9.35%.

San Gabriel's expert witness conducted a series of analyses that established a range of equity costs for his water utilities sample of from 10.6% to 11.6% and for his gas utilities sample of 10.3% to 11.6%, supporting his average equity cost estimate of 11.0%. Based on his conclusion that San Gabriel's cost of equity is greater than that for his benchmark water utilities sample by no less than 120 basis points, he calculated a range of equity cost estimates for San Gabriel of 11.5% to 12.8%. San Gabriel proposed rates calculated to yield an ROE of 11.5%, the extreme low end of its witness' range of equity cost estimates.

DRA's expert witness criticized the 11.5% ROE as unreasonably high due to the use of forecast interest rates above current long-term yields, and excessive risk premium estimates. The City's expert witness expressed similar objections. Both witnesses criticized the relevance of San Gabriel's consideration of a sample of natural gas utilities.

What stands out in a comparison of the testimony of the experts is the inevitable and pervasive use of judgment, which colors all results. We have recently reviewed ROE for San Gabriel in its recent rate cases and found reasonable in 2004, a ROE of 10.10% (D.04-07-034, p. 59); and again in 2005 a ROE of 10.10% (D.05-07-044, p. 33). In this case, San Gabriel and DRA have stipulated to a ROE of 9.90%, the City proposes 9.0%. Having recently considered this matter, we believe a 20-basis point reduction in ROE is more in line with current trends than the City's more drastic 120-basis point reduction. We adopt 9.90% as the reasonable ROE and the overall rates of return of 9.33 for TY 2006-2007 and 9.35% for TY 2007-2008 as stipulated by DRA and San Gabriel (Exh. 85).

X. Revenue Recovery Issues

A. Advice Letter Treatment

San Gabriel seeks to phase into rates by advice letter filings the capital costs for its planned new headquarter complex ($3 million in the 2005 capital budget and $3 million in the 2006 capital budget) and for the post-2005 portion of the Sandhill Plant upgrade project ($18 million in 2006 and $4 million in 2007). San Gabriel believes that advice letter treatment will temper the rate impact on customers by implementing necessary rate increases in smaller increments. While rate changes for the test year and escalation years are intended to be effective as of July 1, San Gabriel proposes to schedule rate increases related to these advice letter projects for January 1 of each year, when water usage tends to be lower than in the summer.

San Gabriel proposes to include the $12 million budgeted for expenditure in 2005 for the Sandhill upgrade project in TY 2006-2007 rate base, but to track other capital expenditures on Sandhill and the headquarters complex, adding an allowance for funds used during construction (AFUDC) or interest during construction (IDC) if not reflected in test year CWIP. It would submit advice letters by November 15 of each year to effect rate increases on the following January 1 reflecting inclusion of those investment and interest amounts in rate base.

DRA recommends that the cost of the Sandhill plant upgrade be removed from plant in service, and that the proposed advice letter treatment for the incremental costs be disallowed. It argues the next GRC is the proper time to make a determination of whether the cost of the upgrade is appropriate, since by that time the new plant should be operational and its capacity can be readily determined. The Company can accumulate charges for IDC so that its investment is protected until such time as a final determination on the project can be made.

We agree with DRA. An advice letter filing for a major addition to plant is not routine. It will have to be reviewed by the Water Division, DRA, possible protestants, and the Commission. Our three-year rate case plan can be seriously adversely impacted. A charge to CWIP will adequately protect San Gabriel. That account includes all direct, indirect, and overhead costs of constructing new utility facilities, both large and small. When a facility under construction is placed into operation, the account balance is transferred to the plant in service account and then, subject to our review, included in rate base.

Similarly, the request to use an advice letter filing for the headquarter complex is denied. However, DRA recommends that San Gabriel be allowed recovery via advice letter of the new Water Treatment Operator III positions after the Sandhill Water Treatment Plant upgrade is in service and the positions are actually filled by San Gabriel. As we discussed earlier in this opinion, these Water Treatment Operator III positions will have to be filled well in advance of the Sandhill upgrades being placed in service, so the new employees can be trained and become familiar with the plant as built. DRA's proposal to use the advice letter process to cover the expense associated with these positions after the Sandhill plant upgrades are placed in service is denied.

B. Memorandum Account

1. Water Quality Litigation Memorandum Account

Early in 2002, in response to the loss of regular service from seven wells that were contaminated with perchlorate, San Gabriel realized the Fontana Division was facing an increase in water quality litigation costs. San Gabriel responded by opening a Water Quality Litigation Memorandum Account in March 2002 to record outside legal expense related to water quality litigation for the Fontana Division. By D.04-07-034, we authorized a 12-month amortization of the July 2003 balance of $1.0 million, which was completed in July 2004. San Gabriel seeks to amortize the balance recorded in the Water Quality Litigation Memorandum Account as of June 30, 2006. In October 2005, the account balance stood at over $2 million.

DRA agrees that water quality litigation costs should continue to be subject to a balancing account and the expenses associated with water quality litigation should be excluded from base rates. DRA, however, takes issue with the timing of the amortization of the costs contained in the account. DRA recommends that recovery of the costs be deferred until the amount of recovery from third parties can be determined. DRA says it is obvious the Company anticipates that the costs of water quality litigation will result in significant recoveries, which are anticipated to exceed the costs incurred. Therefore, it is wrong to charge current ratepayers with the costs by annually amortizing the balancing account in rates when it is the future ratepayers who will receive the benefit of the costs. DRA recommends that these expenditures be deferred to be matched up with the future benefits. The Company is not harmed by the deferral as the balancing account accumulates interest.

San Gabriel objects to deferral of cost recovery. It argues that water quality litigation has become an ongoing Company responsibility with no end in sight. Since San Gabriel is the plaintiff in pursuing the polluters, there is no prospect of recovering its litigation expenses from the Company's insurers. Meanwhile, interest accrues on unrecovered litigation costs. Just as the Commission has urged water utilities to actively pursue the polluters, the Commission should set rates that allow recovery of the costs incurred in that process on a current or near-current basis. Allowing relatively current recovery of accrued litigation costs will not prevent ratepayers from fully benefiting from all recoveries and certainly will not diminish the Company's incentive to seek recoveries from polluters.

We will authorize a 24-month amortization of the June 30, 2006 balance in the account. The lawsuits are for current damages to wells that are, or were, in service for current customers. We believe San Gabriel is actively pursuing polluters and prompt amortization of legal costs will encourage continued pursuit.

2. Water Quality Memorandum Account

DRA recommended that San Gabriel be allowed to continue to maintain a Water Quality Memorandum Account, so that amounts received from polluters or grants received may benefit future ratepayers. The Water Quality Memorandum Account was established in the last GRC, with the intention that any funds received in the future from grants and lawsuits against polluters would be included in that account and ultimately invested in remediation efforts in a way that would shield ratepayers from bearing the costs to the extent such funds were available. Settlements have been treated as contributions toward the capital cost of facilities, thereby reducing rate base. Funds received are recorded as contributions on the Company's books.

This account is a benefit to ratepayers. But it is only a benefit to the extent that San Gabriel accounts for funds. Our discussion of the use of such funds, set forth below, causes us great concern. Funds have been diverted from benefiting ratepayers to benefiting shareholders.

C. Net-to-Gross Multiplier

A key element in calculating revenue requirement is the Net-to-Gross Multiplier, a factor applied to the forecast net income to calculate tax consequences of the required test year and attrition year revenue requirement. San Gabriel's proposed Net to-Gross Multiplier is 1.800324. DRA proposed 1.77286 as the Net-to-Gross Multiplier, the difference being DRA's use of an uncollectibles rate of 0.1951% and a deduction for qualified production activities under the Jobs Act, both items discussed above. We find the Net-to-Gross Multiplier to be _____ based on the resolution of those issues.

D. Calculation of Escalation Year Rates

In accordance with the RCP, year 2007-2008 is a test year for items related to rate base and an escalation year for all other revenue requirement components, and TY 2008-2009 is an attrition year for rate base items and an escalation year for other components. We have followed the RCP requirement for test year, escalation, and attrition factors to produce revenue requirement and rate increase calculations for Escalation Years 2007-2008 and 2008-2009.

XI. Rate Design

A. Facilities Fee

The City proposes that the Commission require San Gabriel to impose a facilities fee for new development receiving water service from the Fontana Division. Other water purveyors in the region charge between $5,000 and $7,000 per new home connected to the system and use those funds to pay for additional capacity needed to serve new customers. The City provided Exhibit 54, a "Capital Development Fee Survey," which calculates an average cost of development fees and the range of such fees for various meter sizes as such fees are assessed by a set of nine public water districts or cities in general proximity to the City of Fontana. DRA takes the position that to the extent any addition to plant is growth related, the cost of the added facilities to serve such growth should be contributed by the developer.

A witness for the City testified that all his current public agency clients assess facility charges in the range of $5,000 to $7,000 on developers to pay for upgrades to accommodate future growth. San Gabriel's witness agreed that this was a common practice for public entities financing infrastructure to serve new developments, and considered this an advantage for public water districts or cities in contrast to Commission-regulated water companies.

A major consideration with respect to potential facilities fees, development fees, connection fees, and the like, was whether the proceeds would be subject to Federal income tax. It is important to describe such a fee in a manner to avoid the payment of taxes. San Gabriel's expert explained that Section 188 of the Internal Revenue Code (IRC) makes advances for construction and CIAC non-taxable for water utilities, while defining CIAC to exclude "amounts paid as service charges for starting or stopping services." He concluded that it would be feasible to implement a non-taxable facilities fee in compliance with a Commission tariff requiring developers or customers to pay for utility plant other than costs to install service connections. Pending the collection of facilities fees, he recommended that the Commission authorize San Gabriel either to include construction costs in rate base as CWIP or to add AFUDC or IDC to the cost of those facilities, which ultimately would be offset in ratemaking by the collection of the facilities fees that could be recorded as CIAC. By connecting the facilities fee to specific projects required for growth, it would be clear that such a fee is not tied to the cost of installing a service line or a charge for connecting to the system or starting service. He did not estimate the amount of the facilities fee or the amount of rate base reduction that could result.

San Gabriel and DRA each submitted late-filed exhibits presenting calculations of the effects of a facilities fee of $5,000 per new connection on San Gabriel's rate base and revenue requirement. San Gabriel recommends that facilities fee receipts through September of each year be recognized as deductions from rate base in conjunction with annual advice letter filings phasing Sandhill upgrade and headquarter complex investments into rates effective January 1 of the following year. Thus, if 1,350 new connections actually are added per year and a $5,000 fee per connection charged during this three-year rate case cycle, over $20 million of facilities fees would be collected from developers and an eventual $4 million per year ratepayer revenue savings.

DRA presented an exhibit with somewhat different calculations of the impacts of $5,000 facilities fee, with estimate ratepayer savings up to $3.20 million per year.

San Gabriel does not oppose adoption of a facilities fee payable by developers or new customers, but San Gabriel is concerned about a number of key issues, which include:

- Given the uncertainty and volatility of real estate development, the revenue that a facilities fee would generate is highly uncertain both in amount and timing. In order to avoid burdening San Gabriel with a new and incremental source of financial risk, it is essential that facilities fee revenues only be taken into account for ratemaking purposes once they have been received, through an advice letter.

- Given the intention of treating facilities fee revenues as CIAC, offsetting additions to utility plant and thereby avoiding increases in rate base, it is important to identify capital projects that are needed, in whole or in part, to serve new customers rather than existing system requirements.

- While it appears to have been assumed that "developers" would be responsible for paying the facilities fee, the existing evidentiary record does not provide a working definition of that term and does not provide a basis for determining what percentage of new service connections are for properties constructed by a "developer," however that term may be defined, or for determining whether a facilities fee would apply with respect to new service connections not involving a "developer."

DRA, the City, and the District all recommend a more direct application of the facilities fee. They point out that San Gabriel has presented the facilities fees as offsets to its proposed future advice letters for the Sandhill plant and the office complex, and not as a CIAC offset to rate base. DRA asserts that the impact, if the facilities fees are adopted, should be shown as an offset to rate base in the test year and each of the escalation years, and not as offsets to proposed future advice letters. DRA disagrees with San Gabriel's proposed advice letter treatment for both the Sandhill plant upgrade and office complex. As shown on joint Exhibit 62a, DRA's proposal would reduce San Gabriel's revenue requirement by $637,815 in TY 2006-2007; $1,902,612 in Escalation Year 2007-2008 and $3,137,472 in Escalation Year 2008-2009.

A facilities fee of a maximum $5,000 for a 5/8" x 3/4" meter is reasonable and will be authorized. San Gabriel has presented persuasive evidence that their customer base is growing by about 2 ½% per year with concomitant growth in water usage. It proposes upgrades to its Sandhill plant, new wells, new reservoirs, and equipment to meet this growth. It is not unreasonable to require new customers to assist in paying for these new facilities through a facilities fee paid prior to connection. The City strongly supports this fee and has submitted a resolution of the City Council affirming its support. The water systems closest to San Gabriel have imposed facilities fees in varying amounts depending on meter size.

Table 1

Water Purveyor	**Meter Size/Fee**	
	3/4"	**1"**
City of Chino	$5,809	$5,809
City of Ontario	$5,147	$5,147
City of Rialto	$5,100	$8,500
West Valley Water District	$5,080	$8,635
City of San Bernardino	$6,375	$8,445
City of Upland	$ 600	N/A
Cucamonga Valley Water District	$2,864	$4,783
City of Colton	N/A	$2,900
Monte Vista Water Company	$3,429	$5,486
Average Cost	**$4,300**	**$6,213**

Based on charges of similarly situated water purveyors we find that a basic fee of $5,000 per 3/4″ meter is reasonable. Higher meter sizes will pay according to the following ratios, as proposed by the Commission's Water Division:

Table 2

Water Division Rate Design Policy Service charge Allocation By Meter Size	
Meter Size	**Ratio**
5/8″ x 3/4" or 3/4"	1.0
1″	2.5
1- 1/2″	5.0
2″	8.0
3″	15.0
4″	25.0
6″	50.0
8″	80.0
10″	115.0
12″	165.0
14″	225.0

We agree with San Gabriel that the revenue the facilities fee will generate is highly uncertain in both amount and timing, given the uncertainty and volatility of real estate development. Therefore, we adopt the following procedure:

1. All fees collected must be recorded in an interest bearing memorandum account and credited to CIAC at the time the fees are spent for additional plant.

2. The utility shall show the balances in its annual report to the Commission. Fund balances should be listed as debits to Account 132, and as credits to Account 253, other credits.

3. Interest should also be debited to Account 132, and credited to Account 421, non-utility income.

4. When plant is replaced using funds from these fees, a debit should be made to the appropriate plant account and a credit made to Account 271, CIAC.

5. The fee is applicable to all customers applying for service from the utility in the territory served for premises not previously connected to its distribution mains, for additional service connections to existing premises, and for increases in size of service connections to existing premises due to change in use.

See Appendix A for a form of tariff.

B. Monthly Service Charges

Since the mid-1980s, a City ordinance has mandated fire sprinklers in all new residential construction. One-inch water meters are required in conjunction with such sprinkler systems and therefore, owners of newer homes in Fontana consequently pay higher monthly service fees than other residential customers the City proposes to equalize the service charge for a 3/4" meter and a 1" meter. San Gabriel's witness opposed this proposal and explained that the higher service charge for a one-inch meter follows Commission guidelines established by D.86-05-064. He did not support imposing additional charges on other Fontana Division customers to subsidize new home owners who are subject to the City's fire sprinkler ordinance.

To modify the service charge to equalize it for new residences would be a change which would benefit occupants of recently constructed homes at the expense of customers with older residences. Such a rate design change would run directly counter to the City's other rate design proposal, a facilities fee.

DRA has reviewed San Gabriel's monthly service charge and finds that it is in compliance with the Commission's Water Rate Design Policy set forth in D.86-05-064. This method is based on 50% of fixed costs being included in the service charges, with remaining costs recovered through a single block commodity charge. DRA takes no issue with the methodology used by the Company.

C. California Alternative Rates for Water (CARW)

In its last rate case, D.04-07-034, the Commission required San Gabriel to implement a low income rate program. Under CARW qualifying customers receive a 50% reduction to their monthly service charge. Within the rate design calculations presented by San Gabriel, the Company has assumed that 30.7% of the Fontana Division's residential customers served through a 1-inch or smaller meter will qualify for the CARW program. That impact is spread over all remaining service calculations. DRA takes no issue with the Company's assumptions and calculations regarding this program.

XII. Water Division Audit Report

A. Background

San Gabriel has two divisions: the Fontana Division and the Los Angeles County Division. In the last Fontana Division rate case decision, D.04-07-034, we ordered our Water Division to audit, prior to Fontana Division's next general rate case, all sale and condemnation proceeds received by San Gabriel from 1996 onwards. Although D.04-07-034 only pertained to the Fontana Division, the proceeds at issue also included proceeds from the Los Angeles County Division. Additionally, in the last Fontana Division rate case, the City of Fontana raised the issue of whether proceeds received by San Gabriel from condemnation, service duplication, and lawsuit settlements related to water contamination had been properly accounted for. This was also part of the Audit Report.

The major findings of the Audit Report are summarized as follows:

- San Gabriel received $27,811,312 in gain from various transactions during the years 1996 to 2004 from:

	Fontana	**Los Angeles**	**Total**
Water contamination (Non-CIAC)	$ 8,559,863	$11,081,498	$19,641,361
Service duplication	$ 2,314,538	$ 1,500,000	$ 3,814,538
Sale on condemnations	$ 2,520,148	$ 709,373	$ 3,229,521
Sale to private property owners	$ 507,199	$ 618,693	$ 1,125,892
Total	**$13,901,748**	**$13,909,564**	**$27,811,312**

- San Gabriel claims that the $27,811,312 proceeds were reinvested in water plant infrastructure in accordance with Section 790.
- Most of the $27,811,312 proceeds do not qualify under Section 790.
- $27,456,307 in net proceeds should be allocated to ratepayers.
- If the Commission accepts San Gabriel's claim that the proceeds qualify under Section 790, San Gabriel did not reinvest the proceeds in Section 790 plant infrastructure.
- $40,855,200 in dividends was paid to shareholders during 1996 to 2004. San Gabriel would not have been able to pay these dividends without the $27,811,312 proceeds received during those years.

San Gabriel asserts that it has accounted properly for the proceeds of all the relevant transactions, has complied with all recordkeeping equipments to Section 790, and properly has reinvested the proceeds in utility plant on which it is entitled to earn its authorized rate of return. It says if the Commission determines that some portion of those transactions and proceeds are not governed by Section 790 or the gain on sale OIR decision, the disposition of proceeds should depend on the relative risks and burdens borne by shareholders and ratepayers.

1. Application of Section 790

In 1995, the California Legislature adopted the Water Utility Infrastructure Improvement Act[1] to address the challenge facing California's investor-owned water utilities to invest in new infrastructure, plant, and facilities to comply with increasingly strict safe drinking water laws and regulations, to develop new and existing sources of supply, and to replace or upgrade existing infrastructure, plant, and facilities. Pub. Util. Code § 789.1(a)-(e). The Legislature declared it was state policy <u>to encourage</u> the utilities to dispose of real property no longer necessary or useful in providing utility service and to invest the proceeds in needed infrastructure, plant, and facilities.

Section 789.1(d) declares:

> (d) Water corporations may, from time to time, own real property that once was, but is no longer, necessary or useful in the provision of water utility service and that now may be sold. <u>It is the policy of the state that water corporations be encouraged</u> to dispose of real property that once was, but is no longer, necessary or useful in the provision of water utility service and to invest the net proceeds therefrom in utility infrastructure, plant, facilities, and properties that are necessary or useful in the provision of water service to the public. (Emphasis added.)

[1] The complete Act is set forth in Appendix B.

In addition, Section 789.1(e) declares:

> It is the policy of the state that any net proceeds from the sale by a water corporation or real property that was at any time, but is no longer, necessary or useful in the provision of public utility service, shall be invested by a water corporation in infrastructure, plant, facilities, and properties that are necessary or useful in the performance of its duties to the public and that all of that investment in infrastructure, plant, facilities, and properties shall be included among the other utility property of the water corporation that is used and useful in providing water service and upon which the Commission authorizes the water corporation the opportunity to earn a reasonable return.

Section 790 implements that policy, providing, in relevant part:

> (a) Whenever a water corporation sells any real property that was at any time, but is no longer, necessary or useful in the performance of the water corporation's duties to the public, the water corporation shall invest the net proceeds, ...including interest. . ., in water system infrastructure. . .necessary or useful in the performance of its duties to the public. For purposes of tracking the net proceeds and their investment, the water corporation shall maintain records necessary to document the investment of the net proceeds. . . . The amount of the net proceeds shall be a water corporation's primary source of capital for investment in utility infrastructure…. .
>
> (b) All water utility infrastructure, plant, facilities, and properties constructed or acquired by, and used and useful to, a water corporation by investment pursuant to subdivision(a) shall be included among the water corporation's other utility property upon which the Commission authorizes the water corporation the opportunity to earn reasonable return.

We have considered the effect of the Infrastructure Act in a number of recent cases, but the seminal case is D.03-09-021, the application of California Water Service Company to increase rates.

We excerpt pertinent portions of our decision.

"We have not previously had occasion to review Water Utility Infrastructure Improvement Act of 1995 (Infrastructure Act), codified at §§ 789 to 790.1. We begin our review by referring to the established principles of statutory interpretation. We summarized these principles quite recently:

> We look to the well-organized principles of statutory construction. The California Supreme Court has stated: "To interpret statutory language, the courts must ascertain the intent of the legislature so as to effectuate the purpose of the law." (*California Teachers Assn. v. Governing Bd. Of Rialto United School Dis.* (1997) 14 Cal.4th 627, 632.) In determining the legislature's intent, they are to "scrutinize the actual words of the statute giving them a plan and common sense meaning." (*People v. Vallodoli* (1996) 13 Cal.4th 590, 597.) "In construing a statute, a court may consider the consequences that would follow from a particular construction and will not readily imply an unreasonable legislative purpose. Therefore, a practical construction is preferred." (C*alifornia Correctional Peace Officers Assn. v State Personnel Bd.* (1995) 10 Cal.4th 1133, 1147.) "In analyzing statutory language, we seek to give meaning to every word and phrase in the statute to accomplish a result consistent with the legislative purpose. . . ." (*Harris v. Capital Growth Investors XIV* (1991) 52 Cal.3d 1142, 1159.) D.02-06-007 <u>citing</u> D.01-11-031.
>
> "We must therefore review §§ 789.1 and 790 and determine the legislature's intent from the plain words of the sections. We are to seek a reasonable and practical interpretation that accomplishes the legislature's goals.
>
> "The legislature made specific findings and declarations of intent in § 789.1. Subsections (a) through (c) concern the need for new improved water infrastructure.
>
> . . .

"Subsections (d) and (e) concern the disposition, in certain circumstances, of water utilities' real property. Specifically, subsection (d) notes that water corporations may own real property that is no longer necessary to provide water service, and that now may be sold. The subsection then announces the policy that water corporations should be encouraged to dispose of such real property and to invest the net proceeds in needed utility infrastructure. Subsection (e) states that the investment of all net proceeds should be included among the water corporation's other utility property, upon which it earns a reasonable rate of return.

"Thus, the first portion of the Infrastructure Act states that water utilities are confronted with increasing needs for investment in infrastructure. These utilities also may have no longer needed real property that can and should be sold to fund the needed infrastructure investments. Finally, the investments should be included among other utility property.

"The second portion of the Infrastructure Act, codified at Section 790, contains the operative portions of the Act. Subsection (a) directs that whenever a water corporation sells any no longer needed real property, the water corporation shall invest any net proceeds in needed water system infrastructure. The water corporation must also maintain records necessary to document the investment of the net proceeds. Subsection (a) further provides that any net proceeds from the sale of no longer needed property will be the water corporation's "primary source of capital" for investment in needed infrastructure.

"Subsection (b) states that infrastructure funded by reinvestment of net proceeds should be included among the utility's other property, upon which it earns a reasonable rate of return. Subsection (c) imposes an eight-year limit on the utility's reinvestment period. Any net proceeds remaining after eight years must be allocated to the ratepayers.

In summary Section 789.1 encourages water corporations to sell real property that is no longer useful in providing public utility service. For the utility to obtain the benefit of Section 790 the proceeds of the sale of real property must be invested in utility infrastructure. It follows that if there is no sale of real property, the Water Utility Infrastructure Act does not apply.

We now turn to the Audit Report.

Overall, the Audit Report addresses $27,811,312 in proceeds San Gabriel received from four categories of transactions during the years 1996 to 2004 in both the Company's operating divisions. By far the largest portion of this total was proceeds from contamination claims not classified as CIAC - $8,559,863 in the Fontana Division and $11,081,498 in the Los Angeles County Division. In both instances, the contamination proceeds at issue were above the amounts reimbursed to the Company for the costs to design, build, and operate wellhead treatment facilities, all of which reimbursement were recorded as CIAC rate base adjustments (for capital) or used to reduce customer revenue requirements (for O&M expenses). Another $2,314,538 in Fontana Division and $1,500,000 in Los Angeles resulted from service duplication claims. Lesser totals resulted from sales in connection with condemnations and sales to private property owners, respectively.

The Audit Report claims that, contrary to San Gabriel's contention, most of the proceeds at issue did not qualify under Section 790 – that is, they were not the proceeds of sales of real property. To whatever extent the proceeds did qualify under Section 790, the Audit Report asserts that San Gabriel failed to reinvest those proceeds in accordance with the statutory requirements. The Audit Report recommends that all of the $27,811,312 in proceeds from the four classes of transactions except for $355,005 in retired plant – a total of $27,456,307 in net proceeds – plus an unspecified amount of interest should be allocated to ratepayers.

Noting that San Gabriel paid more than $40 million in dividends from 1996 to 2004, the Audit Report argued that San Gabriel could not have paid those dividends without the $27,811,312 in proceeds that were the focus of the staff audit. The dividend payments contradict San Gabriel's claim that those proceeds were reinvested in Section 790 plant. The Audit Report recommends that even if the proceeds qualify under Section 790, the net proceeds of $27,456,307 must be allocated to ratepayers.

2. Applicability of Gain on Sale Rulemaking D.06-05-041 in R.04-09-003

On May 25, 2006, the Commission issued its opinion regarding allocation of gains on sale of utility assets. (D.06-05-041.) In that decision we adopted a process for allocating gains (and losses) on sale received by certain electric, gas, telecommunications, and water utilities when they sell utility land, assets such as buildings, or other tangible or intangible assets formerly used to serve utility customers. In most cases, utility ratepayers should receive 100% of the gain from depreciable property such as buildings. Ratepayers and shareholders, however, will split the gain from non-depreciable property such as land and water rights. We said, though ratepayers bear most of the risk associated with such property, a 50% - 50% allocation is a fair and reasonable outcome, partly to compensate for some financial risk borne by the utility, and partly as an incentive to utility management to manage its assets wisely.

The decision provides interpretation of the Water Utility Infrastructure Act 1995, § 789 *et seq.* We found that the Legislature intended the Act to give water companies certainty on how to allocate gains on sale, and to limit Commission flexibility in allocating such gains. We said the statute does not limit our ability to impose record keeping requirements on the water companies to ensure they give notice of planned sales and of how they would invest proceeds from the sale of formerly used and useful utility property in new infrastructure, and we imposed such requirements. We also discussed the treatment of proceeds attributable to property purchased with funds that did not come from the water company, such as developer funds and contamination litigation proceeds.

We said "unless otherwise stated, we also intend the answers to the generic gain on sale questions to apply to water utilities." (D.06-05-041, p. 12.) And we concluded "that incidence of risk is the best determinant of how to allocate gains and losses on sales." (*id.*, p.26.) We found that the Uniform System of Accounts (USOA) accounting categories, while necessary to ensure that utilities maintain their books in a consistent manner, do not control gain on sale allocation. (*Id.*, p. 41.) We reviewed the Infrastructure Act in great detail, but did not resolve all issues. For instance, we declined to decide § 851 issues. We said contamination proceeds do not involve sales of real property, so the Infrastructure Act does not apply, nor are such proceeds gains on sale. Thus, such proceeds are outside the scope of this proceeding. (*Id.*, p. 69.)

San Gabriel took a prominent role in commenting on condemnation gains and involuntary conversion gains. It referred to two types of condemnation for which it contends the utility should receive the proceeds. First, utilities routinely sell property as a result of condemnation or under the threat or imminence of condemnation by a city or other governmental agency. Second, water utilities may also receive proceeds from "inverse condemnation" under the "Service Duplication Law," Pub. Util. Code § 1501 *et seq.* Such condemnations occur when the government constructs water facilities that duplicate the facilities of a private water utility. Under § 1503, the private utility is entitled to compensation for the reduction in value of its property even where the government does not physically acquire the utility property. In both cases, San Gabriel contends the proceeds should be treated as sales proceeds, and the gain or loss passed to utility shareholders. San Gabriel claims such treatment is consistent with the USOA, General Accepted Principles (GAAP) and federal and California income tax rules.

San Gabriel seeks too much. We have consistently maintained that accounting provisions do not control the ratemaking policies which we may determine to be reasonable and necessary; nor are income tax rules controlling. We noted in D.06-05-041 that we had received a great deal of comment on the condemnation (including sale under threat of condemnation) issue; we found the issue requires further consideration. We deferred consideration of this issue to a second, narrowly focused phase of R.04-09-003 proceeding. (*Id.*, p. 77.)

Conclusion of Law 24 is particularly pertinent to this GRC. "Any water utility property that a utility disposes of that does not meet the Infrastructure Act's three criteria – (1) that an asset be sold, (2) that it no longer be used and useful, and (3) that it be real property – shall be accounted for in accordance with our general 100% and 50% - 50% percentage allocations." (*id.,* p. 93.)

3. Sale to Private Parties

When private parties seek to purchase easements or real property in connection with planned improvements, San Gabriel determines if the property is no longer necessary or useful to the company for public utility service. The 24 sales to private parties in the Fontana Division during years 1996 to 2004 mainly involved release of easements or rights of way with lines damaged, threatened, or rendered unusable or hazardous by grading and construction operations. The Water Division agrees these properties were no longer necessary or useful and that $507,199 San Gabriel received from property sales to private owners is governed by Section 790.

4. Condemnations and Sales Under Threat of Condemnation

When a government agency informs San Gabriel that a public improvement project requires acquisition or condemnation of San Gabriel's property, San Gabriel's normal practice is to work out a reasonable settlement and a voluntary sale. San Gabriel documented the circumstances of all ten such transactions between San Gabriel and the City of Fontana, the City of Rialto, or Caltrans, (as well as a minor access agreement with the County of San Bernardino), that were entered into during the years 1996-2004. In such cases, San Gabriel concluded that the affected real property could no longer be used to provide water service, and so was no longer necessary or useful to the company in performing its public utility obligations. The ten condemnations produced $2,520,148 in net proceeds. The Water Division reviewed the San Gabriel engineer reports and found that many of the sold properties were necessary or useful up to the point of the condemnation proceeding. San Gabriel's view is that properties are no longer necessary or useful when they are threatened by condemnation. The Water Division says threatened property may still be physically necessary or useful to a utility, and the utility always has the option of opposing the condemnation action. The Water Division believes it is unacceptable to classify a property as "no longer, necessary or useful" to satisfy Section 790 merely because it is the subject of a condemnation proceeding.

The Water Division is correct. Condemnation is the involuntary transfer of property rights. A sale require a willingness to sell. The Public Utilities Code makes clear that condemnation is a "taking" under eminent domain. (Pub. Util. Code § 1401 *et seq.*"…the political subdivision…shall commence an action…to take such lands, property, and rights under eminent domain proceedings." § 1413.)

San Gabriel agrees that the ten Fontana Division sales on condemnations addressed in the Audit Report were sales under threat of condemnation. San Gabriel contends that all $2.4 million gain of the sales on condemnations addressed in the Audit Report resulted from actual sales, rather than from condemnation proceedings. San Gabriel, as the selling party, admits that it was motivated to avoid the cost and confrontation of a pointless condemnation trial; in the light of that threat San Gabriel did enter into sales transactions.

San Gabriel's admission that it sold under threat of condemnation is the clearest evidence that those "sales" were not "sales" as the term is used in Section 790. The Infrastructure Act was created to encourage water corporations to dispose of real property. It is voluntary sales that are to be encouraged; forced sales need no encouragement. The $2,421,727 net proceed gains from condemnation sales (Audit Report Chapter 8) are not subject to Section 790. Our recent allocation of net gains from condemnation has been 50% to ratepayers and 50% to shareholders. Net gain is the gain after taxes and litigation expense. The ratepayers' portion of the gain will be accounted for by reducing rate base by increasing CIAC by that portion.

5. Compensation for Service Duplication Claims

California law treats a governmental agency's duplication of the service or facilities provided by a privately-owned water utility as a taking of the property of the private utility to the extent it renders the private utility's property useless, inoperative, or reduces its value, and provides for payment of just compensation. (Pub. Util. Code § 1501 *et seq.*) San Gabriel argues that in past cases, even if the public agency did not physically acquire any of the utility's property, the Commission has directed the utility to account for such payments as proceeds of a sale. *San Gabriel Valley Water Co. v. Montebello* (1978), 84 Cal. App.3d 757, *and Re San Gabriel Valley Water Co.*, D.92273 (hereinafter *Montebello*).

The amount in controversy is $2,314,538. San Gabriel claims that these service duplication proceeds qualify under Section 790. DRA and the Audit Report conclude that the $2,314,538 does not qualify as Section 790 proceeds because it was not the result of the sale of real property. There was no real property sale between San Gabriel and the City of Fontana. The settlement agreement with the City did not provide for any transfer of title or interest of property or rights to the City. Instead, the settlement paid San Gabriel just compensation under inverse condemnation by service duplication under § 1501 *et seq.*

San Gabriel contends these proceeds are treated under the California Code of Civil Procedure and under state and federal tax laws as inverse condemnation damages and, pursuant to Pub. Util. Code § 1501, *et seq.*, as an involuntary sale of property. San Gabriel reads the *Montebello* case as one in which the Commission instructed San Gabriel to account for the damage award proceeds in a service duplication case the same as the proceeds of a sale, even though no physical property changed hands. San Gabriel asserts that it has consistently accounted for all compensation from condemnations, including inverse condemnations, in accordance with this Commission's directive, *i.e.,* as a sale of real estate. Accordingly, irrespective of whether the service duplication damages judgment is classified as Section 790 proceeds, the Audit Report is wrong in concluding that the $2.3 million judgment the City of Fontana paid San Gabriel should be allocated to ratepayers or treated as CIAC.

It is clear that damages arising from an inverse condemnation proceeding when no property change hands is not a sale of property. Section 790 does not apply.

6. Proceeds from Contamination Settlement

On November 10, 1998, San Gabriel entered into a settlement with the County of San Bernardino (County) where the County agreed to pay San Gabriel compensation for damaging San Gabriel's property by contamination from the County's Mid-Valley Sanitary Landfill. San Gabriel's reported that it received, for the period 1998 to 2004, $8,559,863 from the County. These proceeds are comprised of the following:

Compensation for damages from 3/1/97 to 12/31/99	$4,052,449
Costs to construct Plant F-10 remediation facilities	3,996,455
Delay in restoring Plant F-10 to full service	455,959
Additional damages (addendum agreement)	55,000
Total	$8,559,863

In addition, the County promised to pay San Gabriel for the actual costs to operate and maintain the Plant F-10 facilities after they were completed. For the period May 2000 to December 2004, San Gabriel incurred

$1,242,057 in actual operating and maintenance costs, and the County reimbursed the costs entirely. These reimbursed expenses were recognized in the last Fontana GRC. Although they were included in test year expense estimates, they were offset by the inclusion of estimates for the reimbursed revenue, and therefore revenue neutral for ratemaking purposes.

Of the $8,599,863 proceeds received from the County, $4,107,449 ($4,052,449 plus $55,000) represented compensation for damages resulting from water contamination from the County's Mid-Valley landfill.
San Gabriel reported no plant assets had to be retired because of the water contamination. San Gabriel, however, did not consider these proceeds as CIAC, and thus, recorded these proceeds into a miscellaneous surplus account.

San Gabriel documented through its job orders that it cost $2,618,291 to construct the treatment facilities for Plant F-10. The Water Division reviewed Plant F-10 construction work orders and determined that San Gabriel was correct. In the last Fontana GRC, D.04-07-034 classified the $2,618,291 as CIAC for ratemaking purposes, and accordingly reduced rate base by the same amount. Although, San Gabriel intends to continue classifying the $2,618,291 as CIAC for ratemaking purposes in the current Fontana GRC, the Water Division found that San Gabriel has not adjusted its accounting records to record the reimbursement as CIAC.

There is an excess of $1,834,123 ($3,996, 455 plus $455,959 received in settlement minus $2,618,291 costs) in proceeds earmarked for Plant F-10 treatment facilities, which San Gabriel received, but did not use for building Plant F-10 treatment facilities. San Gabriel claims that any excess proceeds were reinvested in Section 790 plant infrastructure.

Excluding $2,618,291 of costs to build Plant F-10 treatment facilities from $8,559,863 proceeds that San Gabriel received in the Mid-Valley settlement, there is an excess of $5,941,572 in proceeds that San Gabriel received in the settlement. San Gabriel claims to have reinvested all excess proceeds in Section 790 plant infrastructure.

The Audit Report states that San Gabriel deposited the water contamination proceeds into its general bank account and then commingled these proceeds with all other funds received by San Gabriel. San Gabriel did not set up a memorandum account to track the proceeds received against funds spent. The Water Division was not able to track the spending of the proceeds against funds spent because San Gabriel could not provide appropriate documentation of how it accounted for the funds, segregated them, or otherwise tracked the money. Even if the contamination proceeds qualified under Section 790, without a means of tracking the proceeds to the invested infrastructure by the use of a memorandum account, or by some other equivalent record-keeping system, the Water Division concludes that San Gabriel has not met its burden of showing that it complied with Section 790 by reinvesting the $8,599,863 water contamination proceeds in plant infrastructure. DRA, the City, and the District all support allocating the entire $8,559,863 to CIAC, with no deductions for litigation expenses or taxes.

San Gabriel not only disagreed with the demand that all contamination gains should be allocated to the ratepayers, but asserted that all gains should be allocated to the shareholders.

a) Section 790 Applicability

San Gabriel argues that water rights are real property under California law, and that the County effected a taking of San Gabriel's water rights by rendering them useless due to the contamination that resulted from the County's landfill operations. This amounts to an inverse condemnation and is no less a sale of real property within the meaning of Section 790 than was the assignment of groundwater contamination damage claims approved by the Commission as a Section 790 sale in the recent *Southern California Water Company* case concerning the Charnock Basin. (*Re Southern California Water Company*, D.04-07-031.) Therefore, San Gabriel claims the proceeds received from the settlement of its groundwater contamination claims against the County qualify as a sale of real property, and are subject to reinvestment in utility plant pursuant to Section 790.

San Gabriel's argument is without merit. Its contamination lawsuit was a claim for damages; the settlement damage payment was not a sale of real property nor did it result in a sale. Section 790 requires a voluntary sale by the utility: no sale, no Section 790 relief. In *re Southern California Water Co.* there was (1) a voluntary sale for $5.9 million to Culver City of water rights no longer useful because of contamination and (2) a recovery of some $5 million from oil companies and others who had caused the contamination. We held (1) that the sale of water rights to Culver City was subject to Section 790 because there was an actual sale, water rights are considered real property, and the contamination rendered the water rights no longer necessary or useful; and (2) the $5 million in damages recovered from the polluters should be allocated 100% to the ratepayers. We reasoned that ratepayers had to pay increased rates because of the loss of groundwater and had to pay depreciation and a rate of return on facilities that were rendered useless by the contamination. (D.04-07-031, *mimeo.,* p. 15.)

In the case before us there is not sale of water rights (or any other property). San Gabriel's ratepayers have paid maintenance, depreciation, and return on facilities made useless by the contamination. Following *Southern California Water Co.,* we should award all the gain from damages received from contamination suits to the ratepayers, but we believe the better course is to follow our recent "gain on sale" decision (D.06-05-041) and allocate the gain 50% to ratepayers and 50% to shareholders. This will assure and encourage the utility to vigorously pursue polluters.

b) Application of Section 851

Section 851 provides, in relevant part:

> No public utility….shall sell…any part of its…property necessary or useful in the performance of its duties to the public…without first having either secured an order [or] obtained a resolution from the commission authorizing it to do so….Every sale…made other than in accordance with the [order or] resolution from the commission authorizing it is void….Nothing in this section shall prevent the sale…by any public utility of property that is not necessary or useful in the performance of its duties to the public….

San Gabriel's position is that it is not required by Section 851 to obtain Commission approval for the various sales of real property, including facilities and easements, to government agencies by condemnation or under threat or imminence of condemnation or to private property owners, because in each case San Gabriel had acted pursuant to an engineering memorandum prepared by a San Gabriel engineer documenting the status of the property as "no longer necessary or useful to the company in the performance of its obligations as a public utility."

San Gabriel argues that once a government agency elects to condemn the utility's property, and adopts a resolution finding the agency's planned use more necessary than the utility's, the agency's finding of necessity is not rebuttable, and the only remaining issue normally will be the amount of compensation to be paid. Neither the Company nor the Commission has the ability or authority to prevent such an involuntary sale, and the condemning authority has no need to obtain the Commission's permission to take the utility's property. San Gabriel contends that neither the Audit Report nor any of the parties refuted San Gabriel's showing of the impracticality and futility of applying Section 851 to sales under threat of condemnation as if condemnation was not impending. The Commission should look realistically at these situations and understand that the Commission does not have the legal ability to stop or delay a direct or inverse condemnation action by invoking Section 851.

DRA reads Section 851 to means that utilities must first gain Commission authorization before selling, leasing, or disposing of any of its property that is either necessary or useful in the performance of its duties to the public. Without such authorization, such transactions are void. DRA says it is unacceptable to classify a property as "no longer, necessary or useful" to satisfy Section 790 simply because it is being threatened by imminent condemnation. Many of the properties sold under threat of condemnation were necessary or useful up to the point of the condemnation proceeding. The very fact that San Gabriel received condemnation proceeds for this property reflects the reality that the property had value at the time of condemnation. Thus, since San Gabriel sold properties that were still necessary or useful, San Gabriel should have complied with Section 851 prior to sale.

We need not decided whether or not the property sold under threat of condemnation was necessary or useful. No party is seeking to void the transactions. It is the allocation of gain from the sales that concerns us.

7. Record Keeping

a) Sales to Private Parties

San Gabriel deposited the sales proceeds in a general checking account and claims the proceeds were later reinvested in Section 790 plant infrastructure. San Gabriel, however, did not track these proceeds in a memorandum account. DRA contends that without a means of tracking the proceeds to the invested plant infrastructure by the use of a memorandum account, or by some other equivalent record keeping system, San Gabriel has not met its burden of showing that it complied with Section 790 when it reinvested in plant infrastructure the $507,199 gain from sales to private properly owners..

b) Condemnation Proceeds

San Gabriel treated its condemnation proceeds as it did its property sale receipts by depositing them in a general checking account, and thus commingled them with other cash deposits not related to condemnations. The Water Division reviewed job cost sheets and work authorizations, journal entries, and general ledger postings which San Gabriel claimed would support its investments into plant infrastructure during 1996-2004. The job cost documents disclosed the amounts actually spent on these projects, but did not indicate the funding sources. In fact, some of the projects commenced at a time before San Gabriel even received the proceeds. San Gabriel paid for these projects from the general checking account, where funds came from a variety of sources.

DRA contends that without a means of tracking the proceeds to the invested plant infrastructure by the use of a memorandum account, or by some other equivalent record keeping system, San Gabriel has not shown it has complied with Section 790 by reinvesting in plant infrastructure $2,520,148 of gain from condemnation proceeds.

c) Proceeds of Service Duplication

DRA contends that even if the service duplication proceeds were Section 790 proceeds, San Gabriel again deposited the $2,314,538 into its general bank account and commingled these proceeds with all other funds. San Gabriel claims that these proceeds were later reinvested in Section 790 plant infrastructure, but San Gabriel had not established a memorandum account to track proceeds received or funds spent. In DRA's opinion there is no proof the proceeds were set aside or otherwise segregated so that they could be properly tracked. Without a means of tracking the proceeds to the plant infrastructure by the use of a memorandum account, or by some other equivalent record keeping system, DRA concluded San Gabriel has not shown it has complied with Section 790 by reinvesting in plant infrastructure $2,314,538 of service duplication proceeds.

d) Proceeds from Contamination Settlement

San Gabriel claims that the $8,599,863 of water contamination proceeds are Section 790 proceeds, and claims to have reinvested those proceeds in Section 790 plant infrastructure. To support this, San Gabriel provided a list of completed job orders as evidence of its reinvestment in plant infrastructure, and therefore San Gabriel complied with Section 790.

The Water Division reviewed these job orders, and noted that the dates of these orders ranged from 1996 to 2002, which corresponds to the time San Gabriel received the contamination proceeds. There were, however, no indications that any of the job orders were directly funded by the proceeds, nor were any of the job orders for contamination-related purposes. The job orders were primarily for general improvements: installation of equipment such as fire hydrants, valves, and piping.

San Gabriel does not deny that it commingled all proceeds from the four categories of gains, nor does it deny that it did not record the gains in memorandum accounts. But it strenuously asserts that every penny received was invested in plant, and it provided the confirming documents.

We have reviewed those documents and find that San Gabriel has clearly established that it has maintained detailed records necessary to document its investment in utility plant of the net proceeds of property sales, contamination recovery, and involuntary conversions. Absent guidance or orders from the Commission, San Gabriel provided what it considered appropriate to comply with Section 790. Therefore, to the extent Section 790 is applicable to the proceeds at issue, San Gabriel has reinvested those proceeds in water system infrastructure necessary or useful in performance of its duties to the public, and those proceeds should remain in San Gabriel's rate base.

We agree with San Gabriel's statement that should we determine that some portion of the net proceeds were not subject to Section 790 because the transaction should not be considered a sale of real property subject to Section 790, then we must reach a conclusion, based on other considerations, whether some allocation of net proceeds to ratepayers is justified.

8. Accounting Classifications

The proceeds of all four classes of transactions were deposited in San Gabriel's general bank account, and invested in what the Company considered to be Section 790 utility property. The Audit Report concluded that San Gabriel's recordkeeping for net proceeds from sales and condemnations was inadequate, because it did not protect against commingling of those proceeds with other Company funds and so did not ensure that all proceeds were invested in utility plant. Apparently the Audit Report would require an accounting system to ensure that the very same dollars received in proceeds are reinvested in the water system infrastructure - a concern which is both meaningless and unusual.

San Gabriel treated not only sales to private parties and to governmental agencies but also involuntary conversions by condemnation, service duplication, and contamination as sales of real property for accounting, tax, and ratemaking purposes. The proceeds of real property sales and involuntary conversions were listed in San Gabriel's federal income tax returns.

The outstanding accounting issues are limited to deciding whether San Gabriel should be required to amend its general ledger and prior years' financial statements. We find that because neither of the requested accounting changes would have any ratemaking consequences but would impose costs and difficulties on the Company, we will not require them.

a) Tracking

The need for tracking derives from the requirement of Section 790(a) that "[f]or purposes of tracking the net proceeds and their investment, the [utility] shall maintain records necessary to document the investment of the net proceeds . . . ." San Gabriel's method of tracking the proceeds of various transactions was to deposit the proceeds in the Company's general bank account and invest it in utility property. San Gabriel's documentation tracked the investment of the proceeds by job numbers, referring to utility plant investments made within one year, and exceeding in each case the amount of the proceeds.

The Audit Report contends that because San Gabriel did not establish a memorandum account in which to record proceeds of sales and condemnations, it was unable to determine whether the funding for plant infrastructure came from such proceeds or from operations. Further, out of concern that commingling the proceeds with other cash allows a utility to apply them for non-Section 790 purposes and then replenish the account with other funds, the Audit Report recommended that the Commission require that all such proceeds be deposited into a special bank account restricted to Section 790 investments.

The Audit Report exalts form over substance. Although a memorandum account would be easier to review than San Gabriel's method, we had not required San Gabriel to utilize one for Section 790 proceeds. The records San Gabriel did keep were adequate to show the receipt of funds and the expenditure of funds. Those records are in evidence which we have reviewed and find adequate. We had no trouble following the money trail. The Audit Report standard that the exact dollars received must be the ones expended on Section 790 plan is meaningless. Nor is it reasonable to have San Gabriel open separate bank accounts for Section 790 proceeds. We should not add workload and costs to no benefit. While Section 790 does not require a memorandum account, San Gabriel does not oppose establishing a memorandum account for Section 790 purposes on a going-forward basis. We will require one.

b) Payment of Dividends

The Audit Report includes an analysis of San Gabriel's cash flows (including both Los Angeles and Fontana Divisions) over the years from 1990 to 2004, concluding that San Gabriel would have had a cash shortage after paying dividends but for the cash proceeds gains. The Audit Report contends that payment of over $40 million in dividends during the years from 1996 to 2004 calls into question the investment in Section 790 plant and asserts instead that those proceeds were used to pay dividends. This is the basis for the Audit Report's recommendation that $27.5 million plus interest be allocated to ratepayers.

San Gabriel strongly objected to the allegation that the gains were paid out as dividends. It maintains it always had reinvested the net proceeds in utility plant consistent with Section 790. It refers to legal counsel memoranda giving instructions to reinvest the net proceeds in utility property, and notes that the Company consistently used the net proceeds at its primary source of capital for new projects. San Gabriel's expert testified that the Company's dividends originate from net income, and demonstrated that San Gabriel has had adequate accumulated earnings for all of the dividends it paid during the period identified in the Audit Report.

He said that the Company had a consistent dividend policy to pay dividends equaling about 6% of average common stock equity. The only exception was in 1999, when a special dividend of $4,960,800 was paid from the Company's unrestricted accumulated net earnings, not from proceeds received during that year from the County of San Bernardino which had been directly invested in construction projects. He analyzed San Gabriel's cash flows over the years 1990 to 2004 and concluded that the Company had more than sufficient cash flow from its operations alone to pay shareholder dividends, aggregating $51,026,400, over the 15-year period.

We have independently analyzed San Gabriel's retained earnings, and, assuming no Section 790 issue, we would find that the Company's annual earnings, excluding capital gains and extraordinary items, have been sufficient to pay its annual cash dividends. But the Section 790 issue is the crux of the problem.

During the period 1996 through 2004 San Gabriel paid dividends of $40.9 million. During the same period San Gabriel received $27.8 million in gains from sales, contamination, etc. During that same period, after making its investments in plant which included the $27.8 million gain, San Gabriel had approximately $41.0 million available to pay dividends.[2] It is obvious that San Gabriel could not have paid $40.9 million in dividends and also invested $27.8 million in plant unless it considered the $27.8 million gain as Section 790 proceeds belonging exclusively to the Company.

We have found the $27.8 million gain was not entirely Section 790 funds to be invested in plant for the account of San Gabriel. We have found the ratepayers were entitled to $_________ million of that gain. Had San Gabriel sequestered the ratepayers' portion of the gain it would have fallen that amount short in its dividend payment. Rather than dividends of $40.9 million the maximum dividend would have been $_____. The conservative course for San Gabriel before it paid dividends would have been to request advice from the Commission regarding allocation of the gains. Instead, it paid ratepayer funds to its shareholders. Therefore, we

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[2] *See* Exh. 16, Exhibit A, analysis of cash flows.

find that dividends were not paid solely from accumulated net earnings, but were paid from earnings plus funds that should have been allocated to the ratepayers.

A slightly different analysis of the numbers shows that San Gabriel would have had a cash shortage of $43,088,611 after $51,026,400 in dividends during the years 1990 to 2004, if not for the fact that San Gabriel had received cash of $39,287,285, comprised of $35,179,336 in Other Net and $4,107,949 in Sale of Property Rights. Other Net plus sale of Property Rights include $27,811,312 in gains proceeds that San Gabriel received during 1996 to 2004 from contamination lawsuit settlements, service duplication, sale on condemnations, and sale to property owners. Of the $51,026,400 dividends paid during 1990 to 2004, $40,855,200 was paid during 1996 to 2004. San Gabriel would not have been able to pay $40,855,200 in dividends without the $27,811,311 cash inflow from gains proceeds which included $13,901,748 from the Fontana Division.

From this DRA contends that unless San Gabriel can explain how $40,855,200 in dividends can be paid to shareholders without using the $13,901,748 of Fontana Division proceeds, these proceeds were used for paying shareholder dividends. By using those proceeds to pay dividends, DRA believes San Gabriel had no intention to reinvest the $13,901,748 of Fontana Division proceeds in Section 790 plant infrastructure within the required eight-year period; Section 790 requires that the net proceeds and interest that is not invested after the eight-year period must be allocated solely to ratepayers. Therefore, DRA, the City, and the District recommend that San Gabriel allocate to Fontana Division ratepayers $13,901,478 in net proceeds, plus interest.

We agree with DRA that San Gabriel could only pay $40.9 million in dividends by using the gain proceeds as if they were San Gabriel's exclusively. Section 790 is satisfied if the gain on sale of real property is invested in infrastructure. It is sufficient that the amount of gain can be tracked into utility infrastructure, by company "records necessary to document the investment of the net proceeds…" (Section 790(a).) We have found that San Gabriel's records meet the test of Section 790. DRA's recommendation is denied.

9. Allocation of Proceeds

The Audit Report, adjusted as shown in Exh. 64, identified the following proceeds and net proceeds (after retirements) from transactions relating to the Fontana Division:

	Proceeds	Net Proceeds
Proceeds of contamination claim	$ 8,559,863	$ 8,559,863
Service duplication judgment	$ 2,314,538	$ 2,314,538
Sales under threat of condemnation	$ 2,520,148	$ 2,421,727
Sales to private parties	$ 507,199	$ 431,004
Condemnation proceeds	$ 22,500	$ 22,500
More proceeds of contamination claim	$ 26,114	$ 26,114
TOTAL	$13,950,362	$13,779,746

San Gabriel invested all the net proceeds in new plant necessary or useful for utility service. That new plant is included in the rate base on which San Gabriel has an opportunity to earn a return, except for the

$2,618,291 investment in wellhead treatment facilities at Plant F10, which the Commission already has deducted from rate base as CIAC (D.04-07-034). Thus, the present allocation of net proceeds from the various transactions is, in effect, $11,161,455 to shareholders and $2,618,291 to ratepayers.

a) Calculation of Net Gain

San Gabriel states that in calculating net proceeds the Audit Report did not consider the legal and expert consultant costs incurred by San Gabriel in obtaining the proceeds and the income taxes that must be paid. San Gabriel says those factors are especially relevant with respect to the proceeds obtained in settlement of San Gabriel's claims against the County of San Bernardino in the Mid-Valley Landfill contamination case and against the City of Fontana in a service duplication case, and also with respect to the proceeds from sales under threat of condemnation. San Gabriel claims that $1,050,499 in legal costs attendant to these matters were never included in a memorandum account or recovered through rates. The only memorandum account authorized to accumulate such costs, the Water Quality Litigation Memorandum Account, was not established until 2002, after all costs relevant to the proceeds at issue had been incurred.

DRA opposes any reduction of net proceeds for legal costs. It points out that in prior rate cases, legal expenses were included in the determination of San Gabriel's rates. It refers to the Fontana Division rate case, D.04-07-034, which says "San Gabriel analyzed its outside legal costs over a 10-year period to develop an average, normalized estimate applicable to Fontana Division." (p. 22.) In that decision the Commission adopted San Gabriel's estimate based on a 10-year average. Those ten years included the years in which the legal costs San Gabriel is attempting to utilize as an offset were incurred. Thus, DRA concludes, those costs have already been factored into base rates and have already been recovered. Those legal costs were not deferred on the Company's books in prior years, were not included in a memorandum account for future recovery, and were effectively recovered from ratepayers in base rates. DRA believes that to allow San Gabriel to now offset the net proceeds with legal costs would in effect allow San Gabriel to double recover the legal expenditures. Ratepayers should not be asked to reimburse San Gabriel twice for its litigation expenses.

San Gabriel responds that legal fees and other litigation expenses incurred in achieving a favorable settlement with San Bernardino County were not borne by ratepayers, predated the Commission's authorization of a Water Quality Litigation Memorandum Account, and occurred between rate cases, so the Company bore the entire cost and risk associated with that litigation. Therefore, ratepayers should now pay those costs.

Although we do not agree with DRA's double recovery theory, we find that San Gabriel's response is inadequate. Legal fees are part of its rate case. Merely because they may be more or less than estimated is irrelevant. The argument that ratepayers must pay because litigation is costly and risky is specious. If we were to accede to requests to have the ratepayers pay for past costs, not only could this be retroactive ratemaking, but also would eliminate risk. Perhaps we should reduce ROE to current rates for United States Treasury bonds.

b) Income Taxes

The Audit Report failed to deduct income taxes associated with its recommendation to allocate the net proceeds to ratepayers. San Gabriel contends the Audit Report's proposal is flawed because the Company is obligated to pay those income taxes.

All parties agree that San Gabriel has taken advantage of the tax avoidance provision of the Internal Revenue Code to the full extent permissible for its gains from involuntary conversions.[3] IRS code § 1033 provides:

> § 1033. Involuntary conversions
>
> (a) **General rule.** – If property (as a result of its destruction in whole or in part, theft, seizure, or requisition or condemnation or threat or imminence thereof) is compulsorily or involuntarily converted –
>
> (1) **Conversion into similar property.** – Into property similar or related in service or use to the property so converted, no gain shall be recognized.
>
> (2) **Conversion into money.** – Into money or into property not similar or related in service or use to the converted property, the gain (if any) shall be recognized except to the extent hereinafter provided in this paragraph.
>
> **(A) Nonrecognition of gain.** – If the taxpayer during the period specified in subparagraph (B), for the purpose of replacing the property so converted, purchases other property similar or related in service or use to the property so converted, or purchases stock in the acquisition of control of a corporation owning such other property, at the election of the taxpayer the gain shall be recognized only to the extent that the amount realized upon such conversion (regardless of whether such amount is received in one or more taxable years) exceeds the cost of such other property or such stock. Such election shall be made at such time and

[3] *See*, Exh. 48, Attachment 3b; Exh. 6, Attachment A1-2, A1-7.

> in such manner as the Secretary may be regulations prescribe. For purposes of this paragraph –
>
> (i) no property or stock acquired before the disposition of the converted property shall be considered to have been acquired for the purpose of replacing such converted property unless held by the taxpayer on the date of such disposition; and
>
> (ii) the taxpayer shall be considered to have purchased property or stock only if, but for the provisions of subsection(b) of this section, the unadjusted basis of such property or stock would be its cost within the meaning Section 1012.

The 9th Circuit has held that:

> "The purpose of this section relating to non-recognition of gain in the case of involuntary conversion of property due to condemnation is to relieve the taxpayer of unanticipated tax liability arising from the involuntary condemnation by freeing him from liability to the extent that he reestablishes his prior commitment of capital within the statutory period. *Filippini v. U.S.,* C.A.9 (Cal. 1963), 318 F.2d 841, certiorari denied 84 S.Ct. 267, 375 U.S. 922, 11 L.Ed.2d 165.

This section is to be liberally construed to accomplish its purpose. *Davis v. U.S.* CA.9 (Hawaii) 1979, 589 F.2d 446.

It is uncontrovertible that the purpose of the statute being to "relieve the taxpayer of unanticipated tax liability" it follows that San Gabriel, having no tax liability, cannot charge the ratepayers for phantom taxes. The IRS has not challenged the tax liability; nor should we. We find there is no liability for the gains San Gabriel achieved from condemnations, involuntary conversions, inverse condemnations, and contaminations.

c) Calculating Net Proceeds

San Gabriel and DRA have presented their methods for calculating net proceeds. We find San Gabriel's applicable, in part. To calculate the net proceeds in each class of transaction, the book value, if any, must be deducted. Then legal costs must be deducted to provide the pre-tax net proceeds. (On the facts of this case, we are not deducting legal costs.) Then the applicable income taxes should be deducted. (On the facts of this case we are not deducting taxes.) San Gabriel proposes in late-filed Exhibit 86a, that the appropriate tax factor, combining the effects of federal and state income taxes, is 40.746%. Thus, in San Gabriel's opinion, the net proceeds, net of income tax, are as follows:

Fontana Division	Excess Proceeds	Legal Costs	Net Proceeds	Net of Tax
Contamination	$8,559,863	$208,554	$8,301,291	$4,918,847
Service duplication	$2,314,538	$616,835	$1,697,703	$1,059,569
Condemnation sales	$2,421,727	$225,110	$2,196,617	$1,301,583
Private sales	$ 431,004		$ 431,004	$ 255,387
Condemnation order	$ 22,500		$ 22,500	$ 13,332
Contamination (more)	$ 26,114		$ 26,114	$ 15,474

San Gabriel observes, if the Commission determines that some percentage of proceeds in one or more of the above categories should be allocated to ratepayers, that percentage should be applied only to the "Net of Tax" amounts.

d) Allocation of Net Gain

Looking at the several classes of proceeds, based on the evidence developed in this proceeding we reach the following conclusions:

> <u>Sales to private parties: $431,004</u>. San Gabriel fully documented the status of the properties involved as being no longer

necessary or useful. These sales were made subject to Section 790 and San Gabriel satisfactorily tracked the receipt of proceeds and their reinvestment in water system infrastructure necessary or useful for utility service. These reinvestments should continue to be recognized as shareholder investments included in rate base.

Sales under threat of condemnation: $2,421,727. Condemnation by public authority was threatened or imminent for these properties. A sale forced by imminent condemnation is not a sale within the meaning of Section 790. There is no income tax. The net proceeds of $2,421,727 will be divided 50/50 between shareholders and ratepayers.

Condemnation proceeds: $22,500. This was involuntary conversion by court-ordered exercise of the power of eminent domain. This is not a sale within the meaning of Section 790. There is no income tax. The net proceeds of $22,500 will be divided 50/50 between shareholders and ratepayers.

Proceeds and service duplication judgment: $2,314,538. This was an involuntary taking by service duplication resulting in payment by the City of Fontana to San Gabriel pursuant to a court judgment. This is not a sale within the meaning of Section 790. There is no income tax. The net proceeds of $2,314,538 will be divided 50/50 between shareholders and ratepayers.

Proceeds of contamination claim: $8,559,863 plus $26,114. This was a claim for damages as a result of the destruction in whole or in part of the Company's property and water rights by groundwater contamination from the Mid-Valley Landfill resulting in payment by the County of San Bernardino to San Gabriel pursuant to a settlement. This is not a sale within the meaning of Section 790. For federal tax purposes the Company has considered this the destruction of its property.

There is no income tax. The net proceeds of $8,585,977 will be divided 50/50 between shareholders and ratepayers.[4]

B. Ratemaking Effects

The ratemaking effects of the dollars allocated to ratepayers is to add those dollars to CIAC, thereby reducing rate base by that amount. This shall be done for rate base for TY 2006-2007 and going forward. In regard to the rate base utilized to compute the revenue requirement in D.04-07-034, the dollars allocated to ratepayers will be added to CIAC in D.04-07-034, thereby reducing rate base by that amount. The revenue requirement in D.04-07-034 will be recomputed and the difference in rates for the period June 17, 2004 through the effective date of this decision will be refunded to current ratepayers on or equal costs per ccf of use.

The rate base for this decision is $______. (Appendix ___.) The recomputed rate base for D.04-07-034 is $_____. (Appendix ___.) The recomputed revenue requirement for D.04-07-034 is $________, and the amount to be refunded is $________. (Appendix ___.)

C. Los Angeles County Division

Section 790's applicability to San Gabriel's investments in plant has been decided in this case. The details that relate to the Los Angeles County Division are not within the scope of this proceeding and only Fontana Division dollars are involved. Accordingly, the parties have addressed only the status and ratemaking treatment of proceeds from surplus property sales and involuntary conversions affecting the Fontana Division. The proper

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[4] Because $2,618,291 of this gain has been invested in Plant F-10 and recorded as CIAC only an additional $1,674, 697.50 should be added to CIAC. ($8,585,977 ÷ 2) - $2,618,291 = $1,674,697.50.)

forum for any ratemaking effects in connection with transactions affecting San Gabriel's Los Angeles County Division will be the next GRC for the Los Angeles County Division.

XIII. Assignment of Proceeding

John A. Bohn is the Assigned Commissioner and Robert Barnett is the assigned ALJ in this proceeding.

XIV. Comments on Draft Decision

The proposed decision of the ALJ in this matter was mailed to the parties in accordance with Pub. Util. Code § 311(d) and Rule 77.1 of the Rules of Practice and Procedure. Comments were filed ______________. Reply comments were filed _______________.

Findings of Fact

1. San Gabriel's forecast that its number of active service connections will increase at a rate of 1,350 new connections per year and its estimates of annual use by every customer class except for large industrial customers is adopted.

2. San Gabriel forecasts sales on a weather-normalized basis for most customer classes by applying the New Committee Method to recorded monthly sales over the last ten years. This forecast method is adopted.

3. DRA's estimate of test year sales to Cemex of 250,685 ccf is more reflective of Cemex's current and anticipated water use, and is adopted.

4. DRA's recommendation that sales to CSI be projected at 545,700 ccf, a level 283,140 ccf higher than San Gabriel's test year estimate, is adopted.

5. San Gabriel's approach to the allocation of the $116,909 received from US EPA is to amortize it over three years, increasing the water revenue

account by $38,970 in the test year. San Gabriel's proposal is reasonable and is adopted.

6. A 6.2% unaccounted for water factor is adopted.

7. DRA has reached an agreement with San Gabriel that San Gabriel's proposed $8,509,500 water costs (177.88/AF) forecast for TY 2006-2007, is reasonable. However, as DRA has recommended an adjustment to increase the company's projected sales to CSI by 650 AF, DRA has also increased the projected purchase water costs by $115,622 (650 AF x $177.88/AF) to $8,625,122. DRA's recommendation is adopted.

8. Purchased power costs of $4,659,500, or $0.094782/kWh, forecast for TY 2006-2007 are reasonable and adopted. Purchased power costs go through a full cost balancing account.

9. An annual chemical expense of $637,410 for TY 2006-2007, is reasonable and adopted.

10. Using updated September 30, 2005 escalation factors, DRA's recommendations for materials and supplies expenses are: $142,300 for operations, $282,900 for maintenance and $40,300 for administrative and general expenses. These are adopted.

11. A TY 2006-2007 transportation expense of $619,323 is reasonable and adopted.

12. In projecting TY 2006-2007 postage expense, the company applied non-labor escalation rates as well as the 5.4% postage rate increase. It is adopted.

13. The maintenance expense element of outside services varies directly with the quantities of physical plant. San Gabriel increased to $187,100 the recorded year 2004 amount to reflect both increases in plant and non-labor escalation rates. San Gabriel's estimate is adopted.

14. San Gabriel estimated $287,795 in TY 2006-2007 for non-perchlorate related legal costs, based on a ten-year average expense level, inflated to 2004 dollars, then escalated to TY 2006-2007. To provide for the possibility of high fees we will adopt San Gabriel's estimate, but to also provide for the possibility of a average expense we require San Gabriel to create a memorandum account to record outside legal expenses, capped at $287,795 per year. Money not reasonably expended shall be returned to the ratepayers.

15. Perchlorate related legal expenses are accounted for through the Water Quality Litigation Balancing Account and are not factored into base rates. This is reasonable and adopted.

16. San Gabriel has agreed to use the ECSB labor inflation rates, thereby reducing its proposed revenue requirement for TY 2006-2007 by about $330,000, while also agreeing to apply the September 2005 version of the ECSB escalation factors. We adopt the methodology and apply it throughout to our adopted expenses.

17. The 12 positions that were vacant as of November 14, 2005 shall be removed in determining TY 2006-2007 payroll expense as its normal to have some level of vacancies in any given period.

18. Of the 12 proposed new positions, we approve 11. We do not approve including in expenses one Water Treatment Operator III.

19. Step increase for employees shall be removed from expenses.

20. It is reasonable to substitute ECSB's September 2005 Labor Inflation Rates for San Gabriel's use of ECSB's June 2005 Compensation per Hour Index. This is adopted.

21. Vacation, holiday, and sick leave expenses are adjusted to reflect our adopted revision to payroll.

22. For 401(k) costs, we change the escalation factor from the Compensation per Hour Index to the Labor Inflation Rate and recalculate the expense based on our adopted revisions to payroll.

23. We modify the health and dental insurance expense to reflect the impact of our revisions to payroll.

24. San Gabriel's Business Property and Umbrella Liability Insurance expenses are adopted.

25. We modify San Gabriel's worker's compensation expense by adjusting for the payroll increase which we have adopted and by offsetting the expense by the three-year average of refunds received, $24,000. We will not adjust the Ex Mod factor.

26. San Gabriel's Regulatory Commission expense and amortization is adopted.

27. DRA's proposed uncollectible factor of 0.1951% is adopted, modified to reflect our projected revenue.

28. San Gabriel's incorporated franchise fee expenses based on a five-year recorded average franchise fee rate of 0.8091% is adopted.

29. The general office allocation costs are allocated between the Los Angeles Division and the Fontana Division based on a four-factor allocation formula. It is adopted.

30. The American Jobs Creation Act of 2004 provides for a deduction equal to 3% qualified production activities income in 2005 and 2006 and 6% of qualified production activities income in 2007 and 2008. As the applicable deduction is 3% for 2006 and 6% for 2007, we shall utilize an average deduction rate for TY 2006-2007 of 4.5%. San Gabriel has estimated the percentage of its net income applicable to production activities to be 51.9%, which we find reasonable and adopt.

31. San Gabriel shall compute its income tax expense to reflect the impacts of the 2004 Act.

32. Taxes Other Than Income include property and payroll taxes. San Gabriel and DRA agree on the amount for Other Taxes except for payroll. We adopt their recommendation but will use our independent findings on payroll.

33. The Fontana Division is confronted with increased demand throughout its service area as the result of rapid new development. Recognizing the need for an update plan to address the growing demands on its water supply and distribution system, in October of 2003, San Gabriel prepared a comprehensive Water Master Plan.

34. The Master Plan addressed the rapid growth in the undeveloped northerly portions of Fontana Division's service area and additional industrial growth in the southerly areas, both of which will require new wells along with new reservoirs (for fire flow requirement and peak demand), booster pumps, and transmission and distribution pipelines to provide necessary flows at appropriate pressures.

35. The Master Plan estimates that approximately 25 mgd of additional groundwater supply is needed by the year 2010 in order to meet increased demands and to increase the reliability of the system. This estimate is reasonable.

36. The Master Plan recommends that the Company have redundant well capacity for at least three 2,000 gpm wells. The Master Plan recommends a total of eight new groundwater production wells (including three wells to provide redundant well capacity), each with a capacity of approximately 2,000 gpm, for a total capacity of approximately 16,000 gpm, be installed prior to 2010. This recommendation is reasonable.

37. The Master Plan concluded that the Fontana Division has a current deficiency of 19 mgd under drought conditions, requiring construction of new and replacement wells that will produce at least 25 mgd as well as construction of a seven mgd perchlorate treatment facility that will treat three contaminated wells, in order to overcome the current deficiency, meet year 2010 maximum day demands under drought conditions, and provide sufficient redundancy during emergency interruptions. We find this conclusion to be reasonable.

38. The Sandhill Surface Water Treatment Plant began operation in 1965. The plant relies on surface water diversions from Lytle Creek but often must be shut down and when Lytle Creek has high levels of turbidity that exceed the current treatment capability of the Sandhill plant. The other source of supply for the Sandhill plant is State Water Project (SWP) water that must be blended with Lytle Creek surface water before it can be treated. These blending requirements restrict the capacity of the Sandhill plant to the availability of useable Lytle Creek surface flow. The required shutdown of surface water processing through the Sandhill plant has deprived the Fontana Division of thousands of acre feet of low-cost surface water, including over 25,000 acre feet just in the first five months of 2005.

39. The planned upgrades and pretreatment facilities will permit the Sandhill plant to treat 100% Lytle Creek surface water, 100% SWP water, or any blend of the two. This will restore the full usefulness of the Sanhill plant even when Lytle Creek surface water is unavailable or too muddy, because the plant will be able to process SWP water.

40. The Sandhill plant upgrade project is expected to cost approximately $35 million, to which must be added staffing and maintenance. San Gabriel's

TY 2006-2007 rate base includes $12 million already expended on the Sandhill plant.

41. For new construction the most equitable way to provide recovery in rates is to continue the solution found reasonable in D.04-07-034 to limit rate base growth to 10% per year. We are not disposed to dictate to San Gabriel which plant will be constructed in which order; that is a management decision.

42. New wells are needed to meet the demands of new customers; new customers should be contributing to provide the plant necessary to serve them.

43. The cost of the treatment facility at Plant F25 should be treated as CIAC, if the company recovers funds from its contamination lawsuits. Preliminarily, costs should be recorded in CWIP.

44. San Gabriel has neglected to emphasize developer funds to provide new facilities for new customers. The need for plant arises not only to serve current ratepayers, but also to serve new. New customers should contribute new facilities. We need not decide at this time which facilities will serve new customers.

45. San Gabriel should install a replacement 10,000 gpm CVWD interconnection to maximize deliveries during emergencies.

46. To construct a new office/warehouse, San Gabriel acquired 4.75 acres for the new facility, on December 30, 2004 for $1,102,233 from Rosemead Properties Inc. (Rosemead), an affiliate company of San Gabriel. The acquired parcel was part of an 8.72 acres parcel originally acquired by Rosemead on July 8, 2003 for $1,148,272.

47. Rosemead is owned by United Resources, Inc. (United Resources.) United Resources also owns San Gabriel. Rosemead purchased the property

during the time that San Gabriel was seeking land on which to construct a new office building. The land was expected to go into rate base. When the land was sold by Rosemead to San Gabriel in December 2004 it occurred without any negotiation regarding price.

48. We will allow $591,250 in rate base calculated on the ratio of the size of the parcel Rosemead sold to San Gabriel to the size of the larger parcel of which it was part. We find that San Gabriel should have been charged 55% of $1,075,000, or $591, 250 for the land. This violation of the affiliate transaction is particularly egregious.

49. In regard to the construction of the new office/warehouse, 50% of the proposed cost of $6 million should be considered CWIP during the TY 2006-2007. San Gabriel should dispose of the facilities that are to be replaced via an arms-length transaction to an unrelated third-party, with the gain on the sale going to ratepayers.

50. We would expect a higher CWIP for TY 2006-2007 because of the major projects under construction. We fin that the company's CWIP estimate is probably low, but reasonable.

51. We find reasonable San Gabriel's forecast method for materials and supplies, reflecting plant growth as well as general inflation (using updated inflation factors). San Gabriel's estimate is adopted.

52. The additions to the advance for construction account for the past five years averaged $3 million. The additions projected for 2005-2008 average $2 million. The growth that creates the need for additional plant should be either advanced or contributed by developers. The advance estimate is low but reasonable.

53. The additions to the CIAC for the past five years averaged $1.3 million. The Company's additions projected for 2005-2008 average $850,000.

Historically, the $1.3 million represented approximately 11% of the $11.677 million average of gross plant additions. The difference between the actual and the estimates suggests that San Gabriel understated the projected contributions. We adopt the historical average for contributions of $1.3 million.

54. We adopt San Gabriel's working cash estimate. It was done in accordance with Standard Price U-16.

55. We adopt San Gabriel's methodology in determining the depreciation expense based upon our adopted estimates of utility plant.

56. San Gabriel and DRA stipulated to the capital structure, cost of debt, ROE and overall rate of return for purposes of this GRC, agreeing on an ROE of 9.90%, and overall rate of return of 9.33% for TY 2006-2007 and 9.35% for TY 2007-2008. The stipulation is reasonable and is adopted.

57. DRA and San Gabriel proposed an imputed capital structure, consisting of 40% long-term debt and 60% common equity, an equity ratio approximately half way between the average equity ratio of a group of small water utilities and San Gabriel's actual equity ratio. This capital structure of 40% long-term debt and 60% common equity is reasonable and is adopted.

58. The stipulation between the DRA and San Gabriel results in a cost of long-term debt for each year, 2006-2008, based on the amounts proposed by San Gabriel. The agreed upon long-term debt rates are: 8.44% for 2006, 8.49% for 2007, and 8.54% for 2008. These debt rates are reasonable and are adopted.

59. Consistent with a 9.9% ROE, the overall rate of return for TY 2006-2007 at 9.33% and for TY 2007-2008 at 9.35% is reasonable and adopted.

60. San Gabriel seeks to phase into rates by advice letter filings the capital costs for its planned new headquarter complex ($3 million in the 2005 capital

budget and $3 million in the 2006 capital budget) and for the post-2005 portion of the Sandhill Plant upgrade project ($18 million in 2006 and $4 million in 2007). An advice letter filing for a major addition to plant is not routine. It will have to be reviewed by the Water Division, DRA, possible protestants, and the Commission. Our three-year rate case plan can be seriously adversely impacted. A charge to CWIP will adequately protect San Gabriel. San Gabriel's advice letter proposal is rejected.

61. San Gabriel's proposal to amortize the balance recorded in the Water Quality Litigation Memorandum Account as of June 30, 2006 is reasonable and is adopted. We will authorize a 24-month amortization of the June 30, 2006 balance in the account.

62. San Gabriel shall continue to maintain a Water Quality Memorandum Account.

63. San Gabriel's proposed net-to-gross multiplier is 1.800324. DRA proposed 1.77286, the difference being DRA's use of an uncollectibles rate of 0.1951% and a deduction for qualified production activities under the Jobs Act. We find reasonable a net-to-gross multiplier of ____ based on the resolution of those issues.

64. In accordance with the RCP, TY 2007-2008 is a test year for items related to rate base and an escalation year for all other revenue requirement components, and TY 2008-2009 is an attrition year for rate base items and an escalation year for other components. We have followed the RCP requirements for test year, escalation, and attrition factors to produce the reasonable and adopted revenue requirement and rate increase calculations for escalation years 2007-2008 and 2008-2009.

65. A facilities fee minimum of $5,000 for a 5/8" x 3/4" meter is reasonable and will be authorized. Other water purveyors in the region

charge between $5,000 and $7,000 per new home connected to the system and use those funds to pay for additional capacity needed to serve new customers. San Gabriel has presented persuasive evidence that their customer base is growing by about 2 ½% per year with concomitant growth in water usage. It proposes upgrades to its Sandhill plant, new wells, new reservoirs, and equipment to meet this growth. It is not unreasonable to require new customers to assist in paying for these new facilities through a facilities fee paid prior to connection. Higher meter sizes will pay according to the schedule in Table 2, above.

66. Given the uncertainty and volatility of real estate development, the revenue that a facilities fee would generate is highly uncertain both in amount and timing. Facilities fee revenues should be taken into account for ratemaking purposes once they have been received, through an advice letter.

67. The following procedures is adopted:

    1. All fees collected must be recorded in an interest bearing memorandum account and credited to CIAC at the time the fees are spent for additional plant.

    2. The utility shall show the balances in its annual report to the Commission. Fund balances should be listed as debits to Account 132, and as credits to Account 253, other credits.

    3. Interest should also be debited to Account 132, and credited to Account 421, non-utility income.

    4. When plant is replaced using funds from these fees, a debit should be made to the appropriate plant account and a credit made to Account 271, CIAC.

    5. The fee is applicable to all customers applying for service from the utility in the territory served for premises not previously connected to its distribution mains, for additional service connections to existing premises, and for increases in size of service connections to existing premises due to change in use.

68. To modify the monthly service charge to equalize it for new residences would be a change which would benefit occupants of recently constructed homes at the expense of customers with older residences. Such a rate change would run counter to a facilities fee. San Gabriel's monthly service charge is in compliance with the Commission's Water Rate Design Policy set forth in D.86-05-064. It is reasonable and is adopted.

69. San Gabriel's CARW program is reasonable and is adopted.

70. San Gabriel's Fontana Division received $13,775,746 in gain from various transactions during the years 1996 to 2004 from:

FontanaDivision	
Water contamination	$ 8,559,863
Service duplication	$ 2,314,538
Sale on condemnation	$ 2,421,727
Sale to private property owners	$ 431,004
Condemnation order	$ 22,500
Contamination (more)	$ 26,114
Total	**$13,775,746**

71. The 24 sales to private parties in the Fontana Division during years 1996 to 2004 mainly involved release of easements or rights of way with lines damaged, threatened, or rendered unusable or hazardous by grading and construction operations. Those properties are no longer necessary or useful and the $431,004 gain San Gabriel received from property sales to private owners is governed by Section 790

72. The ten Fontana Division sales on condemnations addressed in the Audit Report were sales under threat of condemnation. San Gabriel, as the selling party, admits that it was motivated to avoid the cost and confrontation of a pointless condemnation trial; in the light of that threat San Gabriel did enter into sales transactions. We find that San Gabriel's admission that it sold under threat of condemnation is the clearest evidence that those "sales" were not "sales" as the term is used in Section 790.

73. The $2,421,727 net proceed gains from condemnation sales are not subject to Section 790. Our recent allocation of net gains from condemnation has been 50% to ratepayers and 50% to shareholders. Net gain is the gain after taxes and litigation expense, if any.

74. The service duplication gain of $2,314,538 does not qualify as Section 790 proceeds because it was not the result of the sale of real property. There was no real property sale between San Gabriel and the City of Fontana. The settlement paid San Gabriel just compensation under inverse condemnation by service duplication under § 1501 *et seq.* It will be allocated 50/50.

75. On November 10, 1998, San Gabriel entered into a settlement with the County of San Bernardino where the County agreed to pay San Gabriel compensation for damaging San Gabriel's property by contamination from the County's Mid-Valley Sanitary Landfill. San Gabriel's received, for the period 1998 to 2004, $8,559,863 from the County.

76. San Gabriel's contamination lawsuit was a claim for damages; the settlement damage payment was not a sale of real property nor did it result in a sale. Section 790 requires a voluntary sale by the utility: no sale, no Section 790 relief. We will allocate the $8,599,863 gain 50% to ratepayers and 50% to shareholders. This will assure and encourage the utility to vigorously pursue polluters.

77. The $22,500 condemnation order and the $26,114 contamination award are not Section 790 proceeds, and will be allocated 50/50.

78. The gain allocated to ratepayers will be accounted for by reducing rate base by increasing CIAC by that allocation.

79. San Gabriel has maintained detailed records necessary to document its investment in utility plant of the net proceeds of property sales, contamination recovery, and involuntary conversion.

80. San Gabriel should not be required to amend its general ledger and prior years' financial statements because neither accounting changes would have any ratemaking consequences but would impose costs on the Company.

81. The records San Gabriel kept were adequate to show the receipt of funds and the expenditure of funds. However, we will require a memorandum account to record all transactions that result in gains from sale of real property, or gains from condemnations, service duplication, or contamination claims.

Conclusions of Law

1. The Water Division shall offer a mediation service to assist the parties in achieving a solution to providing San Gabriel with the City's recycled water.

O R D E R

APPENDIX A
FACILITIES FEES

APPLICABIITY

Applicable to all customers applying for service from the Utility in the territory served for premises not previously connected to its distribution mains, for additional service connections to existing premises, and for increases in size of service connections to existing premises due to change in use.

TERRITORY

This schedule is applicable within the entire territory served by the Fontana Division of the utility.

RATES

Initial Fee for each Service Connection

For 5/8 x 3/4-inch meter..

For 3/4-inch meter ....

For 1-inch meter...

For 1 1/2-inch meter ....

For 2-inch meter...

SPECIAL CONDITIONS

1. Facility fees are payable in addition to and do not limit any charges for extensions of mains that may be applicable under Rule 15, Main Extensions.

2. These fees are not subject to the Public Utilities Commission Reimbursement Fee surcharge in Schedule UF.

3. These fees shall be used only for the repair and replacement or the installation of new infrastructure.

(END OF APPENDIX A)

APPENDIX C
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(END OF APPENDIX C)